MUTUAL FUND INDUSTRY (Part 2)

HEARING

BEFORE THE

SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

OF THE

COMMITTEE ON ENERGY AND COMMERCE HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

SECOND SESSION

SEPTEMBER 27, 1994

Serial No. 103–169

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MUTUAL FUND INDUSTRY

TUESDAY, SEPTEMBER 27, 1994

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ENERGY AND COMMERCE,
SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2123, Rayburn House Office Building, Hon. Edward J. Markey (chairman) presiding.

Mr. MARKEY. Good morning.

Today the subcommittee will address a number of issues of importance to more than one out of four American families that have invested part of their future in one of the Nation's 5,000 mutual funds. The two reports submitted to the subcommittee today by the SEC, one addressing mutual fund investments in derivatives, the other addressing personal trading practices by portfolio managers, confirm that these are complex and far-reaching issues.

The reports also leave no doubt that questions raised by these issues need to be attended to promptly by the industry, by regulators at the Securities and Exchange Commission and among the various States, and in some cases by Congress.

But the significance of these issues and the intensity of the debate about all of these issues is something that is going to command the ongoing attention of this committee. Also, it is important for us to understand the relevance of these issues to the ongoing well-being of the American economy, so there should not be any obscuring of some equally important truths.

First, mutual funds remain the single sector of the financial services industry that has escaped major systemic scandal. The industry has its share of problems, but they are problems that have been confronted openly and constructively.

Second, Chairman Levitt has repeatedly reaffirmed the SEC's commitment to protecting the Nation's 40 million mutual fund investors, has made this objective one of the Agency's highest priorities, and has been supported in these efforts by the fund industry itself. While we are frustrated that we will have to wait for the next Congress before making the SEC a self-funded Agency, we should all be aware that in a time of tight budgets, Chairman Levitt has succeeded in adding nearly 50 new inspectors to his mutual fund team.

Third, the major reasons for investing in mutual funds—a diversified portfolio, professional management, and for the most part, relatively low costs—continue to make good sense to millions of middle-income Americans. Although interest rates reversed course

in February of this year and pushed the stock market into a prolonged slump, Americans have continued to add nearly $400 million to their annual fund investments every business day. While this is less than half of the record pace that prevailed through 1993, it is still a staggering amount of money and is evidence of the continuing trust and faith that investors have in a mode of increasing family wealth that has quite successfully, now for a generation, gained the trust and confidence of investors within our country.

The question of how to characterize this enormous industry fairly and accurately, in light of the problems with derivatives and personal trading that have been so widely reported, reminds me of a story about a shoe manufacturer who was searching for new markets to sell his products. He sent two salesmen to Australia to evaluate the prospect of developing a market among the many aboriginal tribes of the country's spacious interior. The first salesman returned home depressed. He said, "Our prospects are hopeless. These people have never worn shoes." The second salesman returned jubilant. "We must begin shipments immediately," he said. "These people have never worn shoes."

Perspective is obviously important, and I believe that the witnesses here today are well-positioned to help the subcommittee assess the relevant issues fairly and accurately.

Much of today's hearing will focus on the serious practical problems that have arisen for those individuals and institutions which have invested in mutual funds which, in turn, have invested heavily in certain exotic derivatives. The situation is limited to a relatively small number of funds—an important fact that no one should overlook—but at those funds that do have derivatives, we are going to have to, on an ongoing basis, now begin to make some evaluation of whether or not there are safeguards, whether or not there are problems.

In some instances, the outlook appears rather grim. These funds are holding a substantial volume of instruments for which there is no readily available market, a fact which makes the fund less liquid, jeopardizes its ability to establish meaningful and reasonably accurate daily prices and restricts its ability to respond to other market developments.

While we attempt to work out the legal and regulatory issues raised by these investments, others around the country are faced with working out a different set of problems. Municipalities from Texas to Ohio, from Charles County in neighboring Maryland to the Pacific Coast, have lost money from derivatives, and in some cases as a result of their investments in mutual funds. Colleges, pension funds and even an Indian tribe have lost money because of these investments.

For the larger losses, the consequences are painful and dramatic. Schools and roads are not built, services are arbitrarily slashed, and teachers are laid off.

Risk is, of course, an essential element of the investment process. But as Don Phillips wrote in his prepared testimony: a sound regulatory regime must enable investors to reasonably identify and assess the risks that they are taking.

Recent reports suggest that some of the descriptions of the risk associated with mutual fund investments in derivatives are impeding rather than facilitating this process. Three months ago, Congressman Fields and I wrote a detailed letter to Chairman Levitt raising a broad range of issues that related directly to the use of derivatives by mutual funds. Among the key subjects addressed in the letter, and to be discussed here today, were the following questions:

Does the SEC have adequate knowledge of rapidly changing industry practices?

Will better disclosure about derivatives and other risks be accomplished in a manner that makes a significant difference to average investors?

Is intense competition in the fund industry leading some portfolio managers to move risky derivatives into otherwise risk-averse funds?

Are mutual funds experiencing problems pricing exotic derivatives, and if so, what are the possible consequences for investors?

Today's hearing will also address the possible conflicts of interest associated with the practice of personal trading by portfolio managers and perhaps a few other questions as well.

The time for an opening statement by the Chair has expired.

I recognize the ranking Republican member, the gentleman from Texas, Mr. Fields.

Mr. FIELDS. Thank you, Mr. Chairman.

Mr. Chairman, I commend you on calling this hearing on the use of derivative instruments by mutual funds. This is the latest, perhaps the last, hearing on derivatives this Congress, and it is time to reflect on the testimony that has been presented to this subcommittee on the issue.

It is clear that derivatives are now an integral part of the financial landscape. Derivatives have revolutionized financial management and have increased the liquidity and efficiency of the markets.

They have also provided new means of hedging, frequently in markets for which hedges were previously unavailable. Indeed, it is arguable that a manager failing to use derivatives may be unnecessarily exposing his portfolio to losses that can be avoided.

As SEC Commissioner Carter Beese has noted, in most industries, management would not even consider a major business transaction without using risk-management techniques to hedge against the danger of unexpected price or interest rate movements. The same is true of mutual fund managers.

It is also clear that using derivatives is not without danger. And the regulation of derivatives is evolving, as are the instruments themselves, in an environment of global integration.

Consequently, it is unlikely that a single scheme of regulation can be developed, as if in a laboratory, and then imposed on the waiting industry. A better result will be obtained if financial entities like mutual funds are examined and what is appropriate regulation of their use of derivatives is established by trial and error over time. The free enterprise system is at work.

Money market funds, for example, are limited to investing primarily in liquid instruments. Whether they are derivative instruments or not is irrelevant. If full disclosure is made about what derivatives fund managers use and how they use them, investors should be free to accept or reject the additional risk that accompanies the opportunity for higher returns.

Indeed, it appears that some funds are discontinuing their use of derivatives to satisfy the objections of concerned investors. Other funds actively market themselves by highlighting their derivatives expertise. This is as it should be, the free market is the best regulator. And as Federal Reserve Governor Susan Phillips said recently, a flexible regulatory regime is essential if we are to allow market forces to efficiently allocate these resources.

Any regulatory system going beyond requiring disclosure may produce an unfortunate side effect. It may create a public perception that the government is taking steps to guarantee the safety and soundness of investments. Of course, this cannot be true.

Congress can legislate against fraud and manipulation but as we cannot pass a law against bad weather, we cannot protect people from the oscillations of the financial markets.

This subcommittee is familiar with the SEC study that concluded a substantial percentage of investors in mutual funds believed they are federally insured. Is it any wonder that investors believe their principal is safe from loss when they read of an SEC statement listing derivatives that are inappropriate for money market funds to use?

When fund sponsors infuse capital into money markets to replenish lost resources and maintain a dollar a share price, is it unreasonable for investors to imply a guarantee against loss?

In these specific instances, I happen to agree with both of the actions. The SEC and the fund sponsors acted in good faith and should be complimented on their investor protecting initiatives.

As this subcommittee continues its work on derivatives regulation next year, however, we must address the long-term implications of overregulation and paternalistic approaches. Our efforts must underscore the individual responsibilities of all parties to a transaction. It begins with those who recommend derivatives as solutions to financial problems.

The derivative investments of Odessa College in Texas that helped fund the university's growing educational program over the last 3 years by returning 11, 17, and 23 percent annually, did not become unsuitable this year when they lost money. From press reports it appears that all that changed was the quality of the university investment officer's judgement and his decision to ignore a fundamental precept of finance: "Don't put all your eggs in one basket." No amount of regulation will ever be a substitute for good management.

Nor can any amount of regulation remove all the risk to customers in these or any other financial transactions. Derivatives are merely instruments used to shift risk between parties. All legislative and regulatory initiatives must point towards insuring that parties to these transactions are given all the information they need to understand the risk they are being asked to accept. The only workable system of regulation is one in which the end users

of derivatives, ultimately, accept responsibility for the choice of investment vehicles used to obtain their financial goals.

Mr. Chairman, I commend you again for calling this series of hearings. I look forward to the testimony of our distinguished panels today. And yield back the balance of my time.

Mr. MARKEY. I thank the gentleman.

Do other members seek recognition for the purpose of making an opening statement.

The Chair sees none.

We will then turn to our first witness, Hon. Arthur Levitt, the distinguished Chairman of the SEC.

We welcome you back, Mr. Chairman. Whenever you are ready, please begin.

STATEMENT OF HON. ARTHUR LEVITT, JR., CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. LEVITT. Chairman Markey and members of the subcommittee, I appreciate the opportunity to testify on behalf of the SEC in response to your concerns about the mutual fund industry, particularly personal trading by fund portfolio managers as well as the fund use of derivatives.

Mr. Chairman, I have come before you a number of times to talk about the importance of investor protection. At the SEC, the interests of American investors guide our every decision. Safeguarding these interests is not only our goal, it is the goal of everyone who understands that investor confidence is what sustains our capital markets in general and the mutual fund industry in particular. To preserve that confidence, the industry must maintain the highest standards of ethical conduct.

A few months ago those ethical standards were called into question by reports that fund portfolio managers were actively trading for their own accounts. Concerns were raised that portfolio managers might be engaging in abusive trading practices such as front-running—that is, conducting a personal securities transaction before that of a fund, with the expectation that the fund's transaction will favorably affect the price of the securities.

We took those concerns seriously, as did the leaders of the mutual fund industry. For our part, the staff of the Division of Investment Management conducted a special examination of 30 fund groups. I am pleased today to announce some of their findings.

The staff concluded that, among the fund groups examined, the vast majority of portfolio managers do not invest extensively for their personal accounts. More than 40 percent of the managers subject to the examination engaged in no personal trading, while 75 percent engaged in very little. More than 90 percent of the portfolio managers refrained from buying or selling securities ahead of their funds, and almost all of the personal trading that was found took place at a very, very small number of firms.

As the members of this subcommittee well know, we do not as a matter of policy discuss specific firms that we are examining. Nevertheless, I would like to assure you that we are using our inspection authority aggressively to make sure that those firms do not tolerate abusive trading. If we do find abuses, we will not hesitate to bring strong enforcement actions.

The low level of personal investing suggests that the regulatory system already in place generally works well. Therefore, at this time, we are advocating neither mandatory investment restrictions nor a mandatory ban on personal investing. The Investment Company Institute's Advisory Group on Personal Investing has proposed several voluntary measures that will help minimize the possibility of abusive trading. We applaud the ICI's efforts and urge all funds to consider these proposals.

The staff will ask for the industry's response within 6 months, and we very much hope and expect to see everyone on board by then. We will work closely with the ICI to see to it that the maximum number of funds embrace the ICI's standards, which we believe to be minimal standards.

Although our own study didn't find a major problem, we did find room for improvement. And with the popularity and importance of mutual funds at historic levels, we are compelled to see that those improvements are made. Our recommendations aren't going to supplant those of the ICI Advisory Group but will complement them, and in some instances, will amplify them.

Let me give you two brief examples: We are going to ask the funds to disclose publicly their policies on personal trading. We don't want personal investing to take place behind a shroud of secrecy. With disclosure of fund policies, investors can then decide whether they want their money managed by someone who is also trading for his or her own account.

We will also ask each fund's board of directors to review the fund's code of ethics and compliance with that code annually. We want to make sure the directors are the frontline of defense against ethical problems. Our proposal would make it plain that they have an obligation not only to promulgate a code of ethics, but also to make sure that it is being obeyed. We believe that our proposals, combined with self-regulation by the industry, are really sufficient to address this situation.

Just last Friday, I met with several hundred directors of mutual funds. I was impressed with their determination to protect the industry's reputation. They know that some 38 million Americans have now entrusted their hard-earned savings to mutual funds. They also know that investor confidence must be preserved. We believe that it will be.

I cannot emphasize strongly enough the role that I believe should be assigned to independent directors of mutual funds. They must take a more active interest in what is being done at the funds. They must understand the policies of the funds in terms of overall direction and investment strategies. I have asked my fellow Commissioners, along with me, to meet with individual groups of directors, independent directors all over the country, to convey a message that we have been conveying to these boards for the past 9 months.

I now turn to mutual fund use of derivatives. I appreciate the subcommittee's attention to this issue, which has such serious ramifications for investor protection.

Derivatives have received a great deal of attention in recent months. But I believe that no issue related to derivatives is more important than the one we address today. When we talk about de-

rivatives in the context of mutual funds, we are not speaking just about some abstract financial instrument. We are talking about the lives of real people who rely on their investments to send their kids to college, to retire with dignity, in short, to fund both their dreams and their necessities.

The Commission has, I believe, a special responsibility to protect these investors who in many instances have taken their funds from the safety of bank deposits and certificates of deposit and because of a change in interest rates have moved them into mutual funds. I think we have a greater universe of relatively unsophisticated investors today than ever before in the history of our markets.

Mutual funds use derivative products for a wide variety of purposes. Derivatives can increase returns to mutual fund investors and can also reduce their risks. Like any market instrument, derivatives can also increase risks and lead to significant losses. Unfortunately, in recent months we have seen some pretty dramatic instances of the latter.

I have long believed that the Commission faces two very special challenges with respect to derivatives: First, I think we have to improve the manner in which mutual funds communicate with their investors about derivatives, in particular how they convey an understanding of what risks are entailed. Second, the Commission must ensure that mutual funds manage their derivative risks as carefully as possible.

Many derivatives are novel and complex instruments that are not well-understood even by some so-called experts, not to mention the average mutual fund investor. The Commission, however, will not accept novelty and complexity as an excuse for poor communication with investors. Without exception, mutual funds must clearly communicate to investors both how they use derivatives and the effect that derivatives have on fund return and fund risk.

Improving disclosure to investors is one of the Commission's most fundamental charges, and we take it seriously. We are working harder than ever to ensure the adequacy of mutual fund derivative disclosure. The Commission has encouraged funds to enhance investor understanding of risk. As we review fund prospectuses, we continually work to improve derivative disclosure. But the Commission intends to do more—as part of that effort, we are looking at ways to develop a quantitative risk measure for mutual funds.

Liquidity and accurate pricing of fund portfolio holdings are essential to a mutual fund's ability to meet its obligation to redeem shares daily and to pay for redeemed shares within 7 days. The Commission will continue to monitor fund liquidity and pricing determinations as they are affected by derivative instruments. In addition, today I have instructed the staff to prepare for Commission consideration a release that would reduce from 15 percent to 10 percent the permitted level of non-money market fund holdings of illiquid assets.

Late yesterday the effects of derivatives use by some money market funds were underscored. Community Bankers US Government Money Market Fund, a small, institutional money market fund, advised the Commission that it will liquidate—that it will redeem shares tendered for redemption yesterday and thereafter for less

than a dollar. We understand that the fund has notified its shareholders, in writing, of these developments.

While any money market fund breaking a dollar is obviously a matter of concern to us, we don't believe its effects on the capital markets should be overstated. This development should serve as a reminder to investors that a money market fund is not insured, nor is it guaranteed. I want to assure you that the Commission is actively monitoring the situation and will keep you apprised of developments.

I think that this is a situation that I suggested before was going to occur. I don't regard it in any way as a market cataclysm. I think it is part of the process of when new products develop, there will be mistakes, there will be errors, there will be money lost. That is part of a market. That is part of an efficient market, and if it were otherwise, we would not have markets as good and as sound as we presently do.

I have also strongly encouraged the management of every fund that holds derivatives to manage their risks effectively. I have urged managers to ensure that derivative use is consistent with investment objectives, and to address issues of pricing, trading strategies, accounting, and internal controls. I have called upon fund directors to participate actively in this process.

Mr. Chairman, the Commission has devoted and will continue to devote considerable time and attention to such important mutual fund industry issues as derivatives use and personal trading. Other issues will surely arise as well. But it is vital that the SEC not only react to issues, but also chart a course to fulfill our regulatory responsibilities.

Our agenda for the next 6 months includes an intensive outreach to investors, to make sure they understand the marketplace, an enhanced emphasis on compliance issues, and a continuation of our ongoing effort to raise ethical standards in the industry. With your support, especially in securing the resources we need, we will continue to fulfill our mandate to protect American investors.

Thank you very much.

[The prepared statement of Hon. Arthur Levitt follows:]

PREPARED STATEMENT OF HON. ARTHUR LEVITT, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Chairman Markey and Members of the Subcommittee: I am pleased to appear today to testify on behalf of the Securities and Exchange Commission ("Commission") concerning regulation of the investment company industry. I will address two issues the Subcommittee has requested us to consider: personal investing by portfolio managers of investment companies and the use of derivative instruments by investment companies. In addition, I will describe what I believe will be the general focus of the Commission's regulation of the industry in the coming months.

As I am sure you are aware, the investment company industry has grown dramatically in recent years. Since 1980, investment company assets have grown at an annual rate of 23.1%, doubling every four years. Mutual funds, the most popular form of investment company, now account for 86% of the $2.4 trillion in investment company assets.[1] In June 1994, there were 4,901 separate mutual fund portfolios,

[1] The other two major types of investment companies are closed-end funds and unit investment trusts. Unlike mutual funds, closed-end funds do not buy back or "redeem" their shares from shareholders. Unit investment trust investors may redeem their shares through the fund, although sponsors often choose to maintain a separate secondary market. Unlike mutual funds and closed-end funds, unit investment trusts hold a relatively fixed portfolio that is not actively managed.

an increase of 769% from the 564 that existed at the beginning of the 1980s. During that same time period, total mutual fund assets soared from $135 billion to over $2 trillion, an increase of more than 1,445%.

In 1993, net sales of mutual fund shares (including reinvested dividends) averaged $23 billion per month. Contrary to some predictions, fund assets have continued to grow in 1994, although at a slower rate than in 1993. During the first six months of 1994, net sales of mutual fund shares have averaged $15.1 billion per month ($6.9 billion per month from February through June). In none of those six months was there a net outflow of money from mutual funds.

Perhaps more significant than the growth in the number of funds or the assets they hold is the increasing role of mutual funds as an investment vehicle for middle-class Americans.[2] A number of factors, including low interest rates for bank deposits and the popularity of Individual Retirement Accounts and 401(k) plan[3] have caused the percentage of U.S. households that own funds to more than quadruple from 6%, or 12.1 million accounts, in 1980, to approximately 27%, or 97.7 million accounts today.[4] Mutual funds hold more than 17% of all household discretionary assets, more than twice the figure of 10 years ago.

This type of growth would not have occurred without a high degree of investor trust in mutual funds. The fund industry has been relatively free of major scandal in recent years. The Investment Company Act of 1940 (the "Investment Company Act"), the principal federal statute under which the industry is regulated, has to date been proven effective in preventing abusive practices that harm fund shareholders. The industry itself also deserves some of the credit for its generally clean record, which has generated trust by middle-class investors, and, in turn, has fueled the industry's growth.

The industry's past record does not reduce the importance of vigilant oversight of the industry by the Commission. On the contrary, the growth of mutual funds renders the protection of fund investors all the more important, and I have made oversight of the fund industry one of the Commission's highest priorities. As the industry grows and is relied on by more and more Americans, the importance of preventing and, if necessary, punishing abusive practices grows commensurately. The Commission is committed to using both its preventive and punitive capabilities so that investors can continue to invest in mutual funds with the confidence that their trust will not be abused.

The Commission cannot properly oversee the fund industry without adequate resources to devote to the task. While the Commission's staff devoted to overseeing the fund industry has grown significantly since 1983, this growth rate is far slower than that of the industry itself. In 1983, there were $2.8 billion in assets for each staff member; today, there are $8 billion in assets per staff member.

The Commission is concerned about the issues highlighted by today's hearings—personal investing by fund portfolio managers and the use of derivatives by funds—as each has the potential to undermine investor confidence in the industry. Investors will continue to have trust in the industry only if they can be confident that portfolio managers will not use their positions to profit in the securities markets at the expense of the funds they manage. Investors also must be assured that funds appropriately manage the risks of their investments in derivatives and adequately disclose the nature and extent of these investments and the risks associated with them.

Fund managers' personal investment activities and the ethical standards maintained by the fund industry became the focus of media attention early this year.[5] In response to an inquiry from Chairman Markey,[6] I stated last February, and I reaffirm here today, that these issues are of the utmost importance to the Commis-

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[2] *See* Investment Company Institute, *Mutual Fund Fact Book* 85-88 (34th ed. 1994).

[3] A 401(k) plan is an employee-directed, defined contribution pension plan organized in accordance with the provisions of section 401(k) of the Internal Revenue Code. In a defined contribution pension plan, an employee's retirement income is linked to the level of employee and employer contributions and the performance of the investment vehicles selected by the employee.

[4] *See* Georgette Jasen, *Yield-hungry CD Investors Seek Altenatives*, Wall St. J., Oct. 8, 1993, at C1; Robert McGough, *Mutual Funds are Trouncing Rivals in Battle for Billions of Pension Dollars*, Wall St. J., Sept. 9, 1992, at C1.

[5] *See*, e.g., Brett D. Fromson, *Fund Managers' Own Trades Termed a Potential Conflict; Biggest Mutual Fund Firm Tightens Rules*, Wash. Post, Jan. 11, 1994, at A1; Robert McGough, *Mutual-Fund Managers Face Conflicts of Interest While Serving as Directors*, Wall St. J., Jan. 21, 1994, at C1.

[6] Letter from Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission (Jan. 11, 1994).

sion and that the Commission will not hesitate to take action against any fund manager or other insider who places his personal interests ahead of a fund's.[7]

Because of my concern over possible ethical lapses in the mutual fund industry, I instructed the Commission's staff to conduct a special examination to ascertain the extent of personal investing by fund managers and to examine how closely those investments are linked to a fund's investments. From April through July of this year, the staff obtained extensive data from 30 fund groups that collectively managed over $500 billion. The staff examined the personal securities transactions of 622 fund managers employed by those 30 fund groups and compared them to the securities transactions of the 1,053 funds they managed during 1993, the year targeted by the special examination. The staff focused particularly on uncovering evidence of front-running,[8] which occurs when a person engages in a securities transaction ahead of a fund with the expectation that the fund's transaction will have a favorable effect on the price of those securities. The special examination served as the basis for a comprehensive report concerning personal investments by fund insiders (the "Personal Investment Report" or "Report"),[9] a copy of which is being provided to the Subcommittee today with my testimony.

The Report sets out the results of the staff's special examination and contains recommendations designed to improve the oversight of the personal investment activities of fund insiders and to enhance ethical standards throughout the fund industry. The Report also analyzes the federal regulatory framework that governs personal investing by fund personnel, principally section 17(j) of the Investment Company Act[10] and rule 17j-1 thereunder.[11] Finally, the Report assesses the recommendations contained in a report by the Investment Company Institute's Advisory Group on Personal Investing (the "ICI Report").[12]

I would like to highlight for the Subcommittee the most significant findings of the staff's special examination. The vast majority of the 30 fund groups reported moderate to infrequent investment activity by their fund managers, with few potentially abusive transactions. A small number of fund groups, however, reported extensive personal investment activity by their fund managers, including some purchases and sales of securities shortly ahead of the manager's funds. The staff currently is examining all potentially abusive transactions.

The data collected from the 30 fund groups indicated that:

The fund managers whose activities were covered by the examination generally did not invest extensively for their personal accounts. Of the fund managers whose transactions the staff examined, 75% engaged in ten or fewer transactions, while 43.5% did not buy or sell securities at all. The typical manager made only two personal transactions during 1993.

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[7] Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Feb. 9, 1994).

[8] Front-running is illegal under a number of provisions of the federal securities laws. See Memorandum accompanying Levitt letter, *supra* note 7.

[9] Division of Investment Management, U.S. Securities and Exchange Commission, *Personal Investment Activities of Investment Company Personnel* (Sept. 1994).

[10] 15 U.S.C. §80a-17(j). Section 17(j) prohibits persons affiliated with a fund from engaging many fraudulent, deceptive, or manipulative act or practice in connection with the purchase or sale by such person of any security held or to be acquired by the fund, in violation of Commission rules. Section 17(j) expressly authorizes the Commission to require funds and their investment advisers to adopt codes of ethics establishing standards for personal investing by fund personnel.

[11] C.F.R. §270.17j-1. Rule 17j-1 prohibits affiliated persons of a fund from engaging in fraudulent, deceptive, or manipulative acts or practices in connection with personal transactions in securities that are held, or to be acquired, by the fund. The rule requires every fund to adopt a code of ethics designed to prevent the fraudulent acts prohibited by the rule, but does not specify the types of investment restrictions that should be included in the code. In addition, the rule requires every "access person" of a fund to submit quarterly reports of personal securities transactions to his employer. Access persons generally include the officers and directors of a fund and its investment adviser, and any individual who has access to information about a fund's impending purchases and sales of portfolio securities. The term "fund insider" is used in this testimony instead of the term "access person."

[12] Investment Company Institute, *Report of the Advisory Group on Personal Investing* (May 9, 1994). The ICI Report recommended that investment companies and their advisers implement a number of specific restrictions and procedures governing the personal investment activities of their personnel. Among other things, the ICI Report recommended that codes of ethics require personnel to pre-clear their personal transactions, prohibit personnel from acquiring securities in an initial public offering, and require personnel to disgorge profits realized on securities held for less than sixty days. The advisory group's recommendations were unanimously adopted by the ICI's board of governors on June 30, 1994.

Potential conflict of interest situations caused by fund managers buying and selling securities ahead of their funds appear to be infrequent. The overwhelming majority of fund managers did not buy or sell securities during the ten days preceding the purchase or sale of those securities by their funds. In less than 1% of all personal transactions reported to the staff a fund manager purchased or sold securities at a better price than his fund received during the ten days following the manager's transaction. In less than 2% of all personal transactions a fund manager received a better price than some fund in the same fund complex.

Potential conflict of interest situations caused by a fund's purchase or sale of securities already held by the fund's manager appear to be infrequent. Less than 3% of all equity securities purchased by the funds examined were, at the time of purchase, also owned by the fund's manager. Many of these securities were issued by large capitalization companies, and therefore provide a minimal potential for conflict.

A large percentage of personal transactions generally, and of transactions that mirrored fund transactions within a short time frame, were effected by fund managers employed by four of the 30 fund groups.

The data collected from the 30 fund groups may overstate the extent of personal investing and the number of potentially abusive transactions in the mutual fund industry generally. Three of the four fund groups whose managers accounted for most of the personal transactions were included among the 30 fund groups examined specifically because the staff was aware, based on past inspections, that their managers traded actively for their personal accounts.

On the basis of the Personal Investment Report's findings, the Commission has concluded that the regulatory scheme governing personal investing generally has worked well, but should be improved. We intend to move forward quickly to put in place several of the Report's recommendations. We believe that these initiatives will enhance the protection of fund shareholders by (1) making available to the public additional information about fund policies on personal investment by fund personnel, (2) increasing the amount of oversight by fund boards of directors or trustees over codes of ethics and compliance matters relating to the codes, (3) making it easier for both funds and the Commission staff to monitor the personal transactions of fund personnel, and (4) extending the scope of section 17(j) and rule 17j-1 to include instruments other than securities. We believe that these initiatives, together with the industry's general acceptance of the principles reflected in the ICI Report, will enhance ethical standards throughout the fund industry and thereby bolster investor confidence. I will now describe in more detail each of the Commission's initiatives.

First, the Commission believes that funds should be required to disclose publicly their policies regarding personal investing by their investment personnel. Recent press accounts have questioned whether fund shareholders fully understand the potential conflicts of interest presented when fund managers invest for their personal accounts [13] and have stated that many fund groups are unwilling to make the terms of their codes of ethics available to the public.[14] Correspondence received by the staff indicates that some fund shareholders want information about their fund's personal investment policies.

We believe that fund shareholders have a right to know whether or to what extent their fund managers are permitted to invest for their own accounts. We therefore propose to require a fund to briefly describe its personal investing policies in its prospectus and to file its code of ethics with the Commission as part of its registration statement. These changes would make information about fund policies available to fund shareholders and also to the media, which could analyze and compare codes for use by the general public.

Second, the Commission intends to propose amendments to rule 17j-1 that would require a fund's board of directors or trustees to review annually all codes of ethics applicable to the fund and compliance matters related to the codes. This proposal is designed to enhance the board's oversight of fund insiders' personal investment

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[13] *E.g.*, Fromson, *supra* note 5, at A1 ("Unknown to most of the nation's 38 million mutual fund shareholders, many of the fund managers who do the investing use information available only to them and other big investors to speculate for their personal accounts.").

[14] Christopher Phillips, *Keeping Your Fund Manager Honest*, Kiplinger's Personal Finance Magazine, Apr. 1994, at 57, 58 (noting that "[f]unds are tight-lipped about their ethics codes" and that, in response to the author's request, a few of the largest fund groups sent summaries of their codes, while others would not discuss their codes at all, or discussed them only generally, without giving specifics); John Accola, *Only 1 of Top 4 Mutual Fund Firms Reveals Ethics Codes*, Rocky Mountain News, Feb. 6, 1994, at 93A ("Only one of Denver's four biggest mutual fund companies has agreed to a Rocky Mountain News request to provide a copy of their internal guidelines governing personal trading for officers and portfolio managers.").

activities. As I have stated repeatedly and reiterated just last Friday to a group of fund independent directors,[15] fund boards have an obligation to ensure that funds are managed responsibly and ethically.[16] Boards should be satisfied that personal investing is desirable and is not inconsistent with the interests of shareholders. If personal investing is permitted, boards should ensure that the fund's code of ethics contains comprehensive safeguards against abusive trading and conflicts of interest.[17]

Third, the Commission intends to propose an amendment to rule 17j-1 that would require fund insiders to disclose their personal securities holdings at the time at which the insider is first employed by the fund or its investment adviser. Conflicts of interest can arise whenever a fund insider holds the same securities as his fund, regardless of when he acquired the securities.[18] As currently written, rule 17j-1 does not expressly require fund insiders to report their existing personal securities holdings at the time they commence employment with a fund or an adviser. Without such information, a fund's ability to monitor overlap between the manager's personal holdings and the fund's investments is impeded. By requiring such reporting, we believe that funds will be better able to monitor potential conflicts of interest involving personal investing and reduce the potential for abusive investing by fund insiders.

Two of the Commission's other initiatives will require coordination with the National Association of Securities Dealers, Inc. ("NASD"). The Commission believes that funds and their advisers will be better able to monitor the personal investment activities of fund insiders if the NASD adopts a rule requiring its member firms to notify a fund or investment adviser whenever one of the fund's insiders opens an account with the member, and upon request of the fund or adviser, to transmit duplicate copies of the insider's trade confirmations and account statements. For a fund or adviser to monitor effectively its insiders' investment activities for conflicts of interest with the fund, each insider, as required by rule 17j-1, must report all of his securities transactions to his employer.[19] If brokers furnish an insider's employer with the insider's account information and trade confirmations, funds and advisers will have a means of independently verifying the information reported by their employees. The NASD has agreed that it would be useful to consider such a rule amendment.

In addition, the Commission believes, and the NASD agrees, that it would be useful to consider prohibiting the participation by certain fund insiders in "hot issue" public offerings. Hot issues are public offerings of securities that are expected to trade at a premium in the secondary market when secondary market trading begins.[20] Hot issues can be made available to fund insiders by broker-dealers who seek to do business with the fund, potentially interfering with the equitable distribution of the securities and creating at least an appearance of impropriety.[21]

The ability of investment company and investment advisory personnel to purchase hot issues currently is limited somewhat by the NASD's Free-Riding and Withholding Interpretation of its Rules of Fair Practice.[22] We recommend that the NASD

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[15] *Mutual Fund Directors as Investor Advocates*, Remarks of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the Investment Company Institute's Investment Company Directors Conference (Sept. 23, 1994) [hereinafter Levitt Remarks, Directors as Advocates].

[16] *E.g., Mutual Fund Directors: On the Front Line for Investors*, Remarks of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the Mutual Funds and Investment Management Conference in Scottsdale, AZ (Mar. 21, 1994), at 1 [hereinafter Levitt Remarks, Mutual Fund Directors].

[17] *Id.* at 6.

[18] For example, an insider who acquired a stock before his association with a fund may cause the fund to refrain from selling the stock solely to avoid downward pressure on the price of the security.

[19] 17 C.F.R. §270.17j-1(c).

[20] NASD Board of Governors, Free-Riding and Withholding Interpretation of Article M, Section 1 of the NASD's Rules of Fair Practice.

[21] The NASD's Interpretation states that NASD members "have an obligation to make a bona fide public distribution at the public offering price of securities of a public offering which trade at a premium in the secondary market... [T]he failure to [make a bona fide public distribution], especially when the member may have information relating to the demand for the securities or other factors not generally known to the public, is inconsistent with high standards of commercial honor and just and equitable principles of trade and leads to an impairment of public confidence in the fairness of the investment banking and securities business." *Id.*

[22] *Id.* A broker-dealer is prohibited from selling hot issue securities to investment company insiders and employees of other investment-related businesses unless the securities are sold in accordance with the buyer's normal investment practice with the broker, the amount sold to any one buyer is insubstantial in amount, and the aggregate amount of the securities sold by the

consider whether the current restrictions should be replaced with an outright ban that prohibits investment company and investment advisory personnel from purchasing hot issue securities from any NASD-member broker-dealer.

Finally, the Commission believes that Congress should amend section 17(j) to cover purchases and sales by fund insiders of property other than securities. The Commission's existing rulemaking authority under section 17(j) to define and proscribe fraud is limited to transactions involving securities. Increasingly, funds are engaging in transactions involving instruments other than securities, such as futures and other commodities. Because the types of abusive conduct to which section 17(j) was addressed can occur with respect to these financial instruments,[23] we are recommending that Congress amend section 17(j) to cover purchases and sales by fund insiders of property other than securities.

In developing these initiatives, the Commission considered, but decided not to pursue, two possible courses of action that have been the subject of public discussion: imposing a ban on all personal investing by fund insiders, and mandating by Commission rule that certain restrictions and procedures governing personal investing, such as those recently advocated in the ICI Report, be incorporated into every fund's code of ethics.

After careful consideration, the Commission has determined not to advocate prohibiting all personal investing. Our conclusion is based on an analysis of three related issues: the extent of abusive securities transactions by fund insiders; the potential harm to fund shareholders caused by insiders' personal investment activities; and the likelihood that a ban would curb further abusive trading by insiders.

First, the results of the special examination are consistent with the experience of the Commission's examination staff that potentially abusive transactions comprise a small percentage of all personal securities transactions by fund insiders. Second, the majority of personal transactions do not create the potential conflicts of interest with fund shareholders that section 17(j) and rule 17j-1 were designed to prevent. Indeed, rather than preventing harm to fund shareholders, a ban on personal investing could hurt fund shareholders by causing talented individuals to abandon public funds and work for other money managers, such as banks, pension plans, and institutional investors, where they could continue to invest.[24] Third, we are not convinced that a ban would necessarily curb further abusive trading by fund insiders. Such trading already is illegal.[25] Any person who is willing to break the law to engage in front-running or other illegal trading practices probably would not be discouraged by an outright ban.

The Commission's decision not to recommend an industry-wide ban on all personal investing is not intended to indicate that it would be inappropriate for individual funds to prohibit investing by some or all of their personnel. Moreover, a fund's board of directors or trustees, in determining the appropriate restrictions to place on personal investing, should consider whether to ban all personal transactions.[26] In particular, the board should ask fund management for an explanation of the purpose personal investing serves. Even if the board is satisfied that personal investing

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broker to all such buyers is insubstantial and not disproportionate in amount as compared to sales to members of the public.

[23] *See In re Kemper Financial Services*, Investment Advisers Act Rel. No. 1387 (Oct. 20, 1993). In *Kemper*, the Commission sanctioned an advisory firm for failing to supervise one of its employees, who allegedly allocated favorable trades to the firm's employee benefit plan at the expense of the firm's public mutual fund. The trades involved financial futures contracts and not securities.

[24] *See Mutual Satisfaction*, Wall St. J., May 25, 1994, at A16 (editorial) ("[A]n outright prohibition on trading... would impel more top investment pros to leave the public funds, or else to demand far higher salaried compensation and thus boost management fees for mutual [fund] shareholders."); Richard M. Phillips, Christian E. Plaza, and Mitchell B. Birner, *Personal Trading by Persons Associated with Mutual Fund Advisers: A Time for Re-Evaluation*, The Investment Lawyer, at 3, 4 (May 1994) ("To... prohibit investment company employees from managing their personal portfolios could place the mutual fund industry at an unfair competitive disadvantage with other money managers in competing for qualified personnel."); James M. Pethokoukis, *Controversy Has Yet to Sully Funds' Image*, Investor Bus. Daily, Mar. 4, 1994 (quoting A. Michael Lipper, president of Lipper Analytical Services) ("And what I think would happen [with a ban on personal investing] is that the good money managers would leave for hedge funds.").

[25] Rule 17j-1 prohibits fraudulent, deceptive or manipulative acts by affiliated persons of funds in connection with personal transactions in securities held or to be acquired by the fund. Abusive personal investment activities by fund insiders may also violate other provisions of the federal securities laws, such as Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. §80b-6, Section 17(a) of the Securities Act of 1933, 15 U.S.C. §77q(a), Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §78j(b), and rule 10b-5 under the Exchange Act, 17 C.F.R. §240.10b-5.

[26] Levitt Remarks, Mutual Fund Directors, *supra* note 16, at 6.

is not inconsistent with the interests of shareholders, the board should ensure that the fund's code of ethics contains strict safeguards, reporting requirements, and verification procedures.

The Commission also considered but rejected the idea of incorporating specific investment restrictions and procedures into a Commission rule. Congress and the Commission consistently have acknowledged the need for flexibility in designing codes of ethics because no one set of standards is appropriate for every fund.[27] For example, in adopting rule 17j-1 in 1980, the Commission noted that "the variety of employment and institutional arrangements utilized by different investment companies renders impracticable a rule designed to cover all conceivable possibilities."[28] The Commission concluded that "the current approach [embodied in rule 17j-1] is more desirable [than mandating or suggesting particular standards] because it gives maximum flexibility to the entities which must design the codes of ethics."[29] A fund that invests primarily in securities of large capitalization companies traded over major exchanges, for example, may not need as many restrictions in a code of ethics as a fund that invests in thinly traded securities of smaller capitalization companies. In addition, a fund that seeks to mirror the performance of a particular index may not require the same restrictions as a fund that invests primarily in a particular industry sector or in the securities of companies located in a foreign country. We believe that the need for flexibility is even more compelling today than it was in 1980 because today there is a greater variety of fund types.

Although the Commission does not believe that we should mandate one set of standards for the entire fund industry, we believe that the code of ethics provisions recommended by the ICI advisory group are a decisive initiative addressing the conflicts of interest that result from personal investing by fund insiders. All of the recommendations in the ICI's Report should be considered by the management and board of each fund. We believe that, absent special circumstances, funds should adopt these recommendations, in whole or in substantial part, tailored as necessary to meet each fund's individual characteristics. The ICI expects that 85-90% of the industry will revise their codes of ethics to meet the standards of conduct reflected in the ICI Report.[30]

The Commission, in addition to moving forward with the initiatives described above, will continue to monitor whether the regulatory scheme governing personal investing by fund personnel adequately protects fund shareholders, and whether fund officers and directors are adopting strict personal investment policies and scrutinizing the personal investment activities of their employees. As part of its monitoring, the Commission will request preliminary information from the ICI within sixty days regarding the number of funds that have adopted or plan to adopt the advisory group's recommendations. The Commission will then request a final report on this topic from the ICI within the next six months. If, in light of these reports, it appears necessary or appropriate in the public interest, the Commission will propose rule amendments or recommend legislation to impose stricter and more uniform standards on the fund industry.

I note that the Personal Investment Report, like section 17(j) of the Investment Company Act, addresses only those actual and potential conflicts of interest that arise when a fund insider purchases or sells securities for his personal account. The Commission is well aware, however, that there is a wide variety of unethical and potentially fraudulent practices in which fund insiders may engage. A fund manager creates a potential conflict of interest with fund shareholders, for example, when he invests fund assets in a company that employs or otherwise is associated with the manager or his family members, friends, or business associates, even if the manager does not own the company's securities.[31] I want to emphasize that practices by which a fund manager places his own (or a third party's) interests ahead of the

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[27] *See, e.g.*, H.R. Rep. No. 1382, 91st Cong., 2d Sess., at 28 (1970) and S. Rep. No. 184, 91st Cong., 1st Sess., at 29 (1969) ("The ability to deal with [personal securities] transactions by rule is intended to permit the Commission to draw flexible guidelines to prohibit persons affiliated with investment companies, their advisers and principal underwriters, from engaging in securities transactions for their personal accounts when such transactions are likely to conflict with the investment programs of their companies.").

[28] Investment Company Act Release No. 11421 (Oct. 31, 1980).

[29] *Id.*

[30] Brett D. Fromson, *Mutual Fund Industry Panel Would Curb Personal Trades*, Wash. Post, May 10, 1994, at C5.

[31] It has been reported that one fund manager caused his funds to purchase large stakes in a private company whose executives included the manager's sister, and in a fledgling company whose investment banker was a firm part-owned by the manager's son. *See* Diana Henriques, *Questions of Conflict Sting Mutual Funds*, N.Y. Times, Aug. 7, 1994, at A1.

fund's interests are prohibited by the antifraud provisions of the federal securities laws.

I assure you that, through our inspection and enforcement programs, we will seek to discover and deal with severely those who engage in abusive or unethical practices, as well as any fund personnel whose investing activities place their personal interests ahead of their funds. The Commission believes that an aggressive inspection and enforcement program is the most effective deterrent to abusive trading. Inspections and enforcement actions will continue to be effective, however, only if sufficient resources are allocated to these programs.

I will now turn my attention to another area of concern to this Committee and the Commission—mutual funds' use of derivatives. Mutual fund investments in derivatives raise significant investor protection concerns in a number of areas—disclosure, pricing, liquidity, leverage, and risk management. The term "derivative" may cover a wide variety of instruments, however, and public debate concerning the issues raised by mutual fund use of derivatives is often complicated by imprecision regarding the instruments that raise a particular issue.[32] Indeed, the public debate about "derivatives" sometimes suggests that a "derivative" is any complex instrument that has caused losses. I would urge the Subcommittee, as it studies the significant issues raised by mutual fund use of derivatives, to focus on the specific instruments that raise investor protection concerns and on the specific issues raised.

Mutual funds, other than money market funds, use derivative products for a wide variety of purposes, including hedging interest rate, currency, and other market risks; substituting for a direct investment in the underlying instrument; or increasing returns. Money market funds also invest in debt instruments sometimes referred to as derivatives that have interest rates that are adjusted periodically based on changes in market interest rates. Many non-money market funds have the authority to use derivative instruments, but our inspections to date suggest that the use of derivatives by most of these funds is limited. There are exceptions, however, to this general observation. Funds primarily investing in mortgage-backed securities, for example, generally have significant investments in derivatives. Long-term municipal bond funds use derivatives to seek increased tax-exempt returns. In addition, funds investing internationally may use derivative investments to lessen currency risks.

A recent industry survey of non-money market funds also suggests that mutual fund use of derivatives is limited.[33] The survey reported that the total market value of all derivatives held by participating funds was $7.5 billion, representing 2.13% of the total net assets of all funds reporting derivatives holdings and 0.78% of the total net assets of all funds participating in the survey.[34] The survey also indicated that the level of use of derivatives varied by fund type, with fixed income funds accounting for 84% of the total market value of all derivatives held by reporting funds.[35]

Although the use of derivatives by mutual funds generally appears to be limited, some funds have recently experienced problems relating to derivative investments. Several short-term government bond funds have experienced significant losses from

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[32] The term "derivative" may be defined as an instrument whose value is based upon, or derived from, some underlying index, reference rate (*e.g.*, interest rates or currency exchange rates), security, commodity, or other asset. *See, e.g.*, Group of Thirty Global Derivatives Study Group, *Derivatives: Practices and Principles* 2 (July 1993). The term "derivative" generally is used to embrace forwards, futures, swaps, and options. *See, e.g., id.* at 28-34; U.S. General Accounting Office, *Financial Derivatives: Actions Needed to Protect the Financial System* 5 (May 1994). The term is also commonly used to describe instruments that are created by splitting other financial instruments into constituent pieces, *e.g.*, mortgage derivatives. *See, e.g.*, James K. Glassman, *Mortgages, and Governments, Can Get Sliced and Diced*, Wash. Post, Sept. 7, 1994, at F1.

[33] Investment Company Institute, Derivative Securities Survey (Feb. 1994). Survey respondents included 52 fund complexes with 1,728 non-money market funds holding aggregate net assets of $958 billion (76% of industry assets in non-money market funds). The survey was limited to a quantitative investigation of the use of derivatives by mutual funds and did not attempt to measure associated risks. *Id.* at 1.

[34] The total notional amount of these derivatives was $54.3 billion, representing 15.51% of the total net assets of all funds reporting derivatives holdings and 5.67% of the total net assets of all funds participating in the survey. "Notional amount" was defined in the survey as "the maximum theoretical exposure presented by the instrument, *i.e.*, the amount whose changes in value impact the fund's net asset value."

[35] Fixed income funds accounted for 62% of the notional amount of all derivatives held by reporting funds.

mortgage derivatives.[36] In addition, losses in the value of certain adjustable rate notes held by some money market funds have resulted in the funds' advisers electing to take actions, including contributing capital or purchasing instruments held by the funds, to prevent the funds' per share net asset values from falling below $1.00.[37] Although the reported problems have affected a limited number of funds and fund types, they raise investor protection issues that merit serious consideration.

Months before these reports surfaced, the Commission expressed concern about investor protection issues raised by mutual fund investments in derivatives. Since the summer of 1993, the Commission has taken a multi-faceted approach to mutual fund use of derivative instruments, focusing on a broad range of issues, including disclosure, pricing, liquidity, leverage, and risk management. A staff task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types, and the Commission's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses. In addition, the Commission's inspection staff is examining and reporting on the derivatives activities of each fund inspected, and has conducted special examinations of certain funds holding significant positions in derivatives. In the coming months, we plan to take additional steps to address mutual fund use of derivative instruments.

The Commission believes it is critical that investors receive understandable disclosure about the manner in which a mutual fund uses derivatives and, in particular, the associated risks. Fund prospectuses convey a range of information to investors, including the fund's investment objectives and policies, permitted investments, and associated risks.[38] The Commission's goal is that this information, taken together, communicate to investors a comprehensible and accurate picture of the fund's investment strategies and its risk/return profile.

In reviewing fund prospectuses, we have found that funds generally provide investors with a list and technical description of instruments, including derivatives, that are permissible fund investments. Funds often describe the purposes for using particular derivative instruments (*e.g.*, to hedge currency risks), but typically provide only the most general information on the risk level of the fund taken as a whole or on how derivative instruments, taken as a group, modify that risk level.

To address disclosure issues, last February the Commission staff issued a letter to all registered funds, noting that in many cases fund disclosures regarding derivative instruments are unduly lengthy and technical. The letter encouraged funds to identify areas of derivatives disclosure that could be modified to enhance investor understanding of the risks associated with derivative investments.[39]

The Commission continues to work to improve derivatives disclosure through our review of fund prospectuses. In addition, we intend to take steps to enhance the quality of risk disclosure provided to investors. In particular, we are considering a requirement that mutual funds disclose some form of standardized, quantitative risk measure in their prospectuses. Such a measure could have significant benefits for investors by providing a means of comparing risks across and within fund types, particularly for fixed income funds whose market risks may be less well understood by investors than those associated with equity funds. The Commission intends to issue a release early next year that will seek public comment regarding whether funds should be required to disclose a quantitative risk measure and what that measure should be.

Mutual funds must stand ready to redeem shares daily and make payment for redeemed shares within seven days after a shareholder tenders his shares.[40] They must compute their share price daily based on market values of fund assets and sell and redeem fund shares at the price next computed after receipt of an order to purchase or redeem.[41] To meet these obligations and maintain investor confidence, mutual funds must maintain highly liquid portfolios consisting of instruments that can be valued accurately.

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[36] *See, e.g.*, Robert McGough, *Piper Jaffray Acts to Boost Battered Fund*, Wall St. J., May 23, 1994, at C1; Andrew Bary, *Derivatives Undo a Popular PaineWebber Fund, Triggering 4% One-Day Drop in Its Value*, Barron's, May 16, 1994, at MW12.

[37] *See, e.g., A History of Stepping Up to the Plate*, Fund Action, Sept. 12, 1994, at 9.

[38] Investment Company Act Form N-1A, Items 1 and 4.

[39] Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Investment Company Registrants (Feb. 25, 1994).

[40] Investment Company Act §22(e), 15 U.S.C. §80a-22(e).

[41] Investment Company Act §§2(a)(41) and 22(c), 15 U.S.C. §§80a-2(a)(41), -22(c); Investment Company Act rules 2a-4 and 22c-1, 17 C.F.R. §§270.2a-4, .22c-1.

Some derivatives may be illiquid or difficult to price under certain market conditions.[42] This has been the case, for example, during recent months in the market for certain collateralized mortgage obligations, where decreased liquidity has resulted in the deterioration of accurate market pricing information.[43] The Investment Company Act and Commission rules contain significant safeguards designed to prevent problems resulting from pricing difficulties and portfolio illiquidity.

As described above, mutual funds are required to sell and redeem their shares at a price based on the current value of portfolio assets. When reliable market quotations are not readily available for a fund's assets, the fund is required to use fair values as determined in good faith by its board of directors.[44] In addition, the Commission has published a guideline requiring that mutual funds generally limit their investments in illiquid assets to 15% of net assets (10% in the case of money market funds).[45] An asset is considered to be illiquid for these purposes if a fund cannot dispose of the asset in the ordinary course of business within seven days at approximately the value at which the fund has valued the investment.[46] Whether a particular asset is illiquid generally must be determined under guidelines and standards established by the fund's board of directors or trustees.[47]

The Commission is not persuaded that legislative changes are needed at this time to address pricing and liquidity issues raised by derivatives. We intend, however, to continue to evaluate these issues in our inspections and will perform targeted examinations to obtain more information on them. If appropriate, we will consider issuing rules to address proper procedures for pricing and liquidity determinations. In addition, I have directed the staff to prepare a release for the Commission's consideration that will modify the guidelines to reduce the limit on non-money market fund illiquid holdings from 15% to 10%.

The Commission is concerned by the leverage that is potentially made available to mutual funds through the use of certain derivative instruments.[48] The potential for increased volatility from such leverage may result in significant losses to investors.

The Commission believes that one of the most effective means for addressing leverage concerns associated with mutual fund use of derivatives is improved risk disclosure along the lines discussed above. The risk/return profile of a mutual fund may be affected significantly by derivatives that introduce leverage, and the Commission believes that it is absolutely critical that fund investors understand this profile.

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[42] In general, there is a close relationship between the liquidity of an instrument and the ease with which the instrument may be priced. If a security trades in a liquid market, there is a strong likelihood that reliable market prices will be readily available. Conversely, reliable prices for securities traded in an illiquid market are often difficult to obtain.

[43] *See, e.g.*, Saul Hansell, *Markets in Turmoil: Investors Undone: How $600 Million Evaporated*, N.Y. Times, Apr. 5, 1994, at A1.

[44] Investment Company Act § 2(a)(41)(B), 15 U.S.C. § 80a-2(a)(41)(B); Investment Company Act rule 2a-4(a)(1), 17 C.F.R. § 270.2a-4(a)(1). In addition, it is the Commission staff's policy that pricing errors should be corrected when discovered, and fund sponsors or service providers should reimburse shareholders who have experienced a material economic loss due to the errors.

[45] *See* Investment Company Act Rel. No. 5847 (Oct. 21, 1969) [35 FR 19989 (Dec. 31, 1970)] [hereinafter Rel. 5847]; Investment Company Act Rel. No. 18612 (Mar. 12, 1992) [57 FR 9828 (Mar. 20, 1992)]; Letter from Marianne K. Smythe, Director, Division of Investment Management, to Matthew P. Fink, President, Investment Company Institute (Dec. 9, 1992).

[46] Guidelines for Form N-1A, Guide 4.

[47] *See* Merrill Lynch Money Markets Inc. (pub. avail. Jan. 14, 1994) (commercial paper issued in reliance on registration exemption in section 4(2) of Securities Act of 1933); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Investment Company Registrants (Jan. 17, 1992) (government-issued interest-only and principal-only securities backed by fixed-rate mortgages, municipal lease obligations); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Catherine L. Heron, Investment Company Institute (June 21, 1991) (municipal lease obligations); Investment Company Act Rel. No. 17452 (Apr. 23, 1990) [55 FR 17933, 17940-41 (Apr. 30, 1994)] (Rule 144A securities, foreign securities). The Commission and the staff, however, have taken the position that certain classes of instruments are generally illiquid. *See, e.g.*, Rel. 5847, *supra* note 45 (restricted securities).

[48] Certain derivatives involve leverage because they create a fund obligation or indebtedness and enable the fund to participate in gains and/or losses on an amount that exceeds its initial investment. Examples are futures, forwards, and stock options sold by funds. Other derivatives provide the economic equivalent of leverage because they display heightened price sensitivity to market fluctuations, such as changes in stock prices or interest rates. In essence, these derivatives magnify a fund's gain or loss from an investment in much the same way that incurring indebtedness does. Examples are purchased stock options and leveraged inverse floating rate bonds.

The Commission is also reexamining the Investment Company Act's limitations on a fund's use of leverage,[49] which were intended in part to limit the volatility of mutual fund shares.[50] The Commission and its staff have applied these limitations to mutual fund investments in certain derivative instruments.[51] The leverage restrictions, however, were originally designed to address a different problem,[52] and they have proven to be a somewhat crude tool for addressing the leverage issues raised by derivatives. For this reason, we intend to issue a release that will seek public comment on appropriate regulatory and legislative solutions to address the issues raised by leverage resulting from fund use of derivatives.

The Commission has paid particular attention to the use of derivatives by money market funds.[53] Money market funds form a particularly important segment of the mutual fund industry because, despite the disclaimers, individual investors often perceive these funds as the functional equivalent of insured bank accounts. Over the past two-and-one-half years, the Commission has been looking at money market fund use of financing engineered instruments that may be able to achieve their intended results only in a favorable interest rate environment. In particular, we have been concerned that money market funds have purchased new types of adjustable rate instruments whose market values may not return to par at the time of an interest rate adjustment, with the result that fund share price stability could be threatened.[54]

The Commission raised this issue last December in proposing amendments to rule 2a-7 under the Investment Company Act, the Commission's money market fund rule.[55] Several months ago it became apparent that some funds continued to hold these types of securities. Because of an increase in interest rates, the volatility of these instruments continued to increase. In June, I raised this issue in correspondence with the chief executive officers of the 50 largest fund complexes.[56] Later that month, the Commission staff provided money market funds and their advisers with additional guidance concerning investments in adjustable rate securities.[57]

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[49] Section 18(f) of the Investment Company Act prohibits mutual funds from issuing any "senior security" other than a borrowing from a bank. Bank borrowings cannot exceed one-third of a fund's assets. Investment Company Act § 18(f), 15 U.S.C. § 80a-18(f).

[50] *See, e.g.*, Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7); *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. 288, 1027-31 (1940) [hereinafter *Senate Hearings*].

[51] The Commission and the staff have applied section 18 of the Investment Company Act to derivative investments, such as futures, forwards, and written options, that create a fund obligation or indebtedness. The Commission and the staff have required funds to "cover" the obligations these instruments create by establishing segregated accounts consisting of cash or certain other high-grade, liquid assets in an amount at least equal in value to the obligations. The Division has also permitted funds to cover certain derivatives by holding the underlying instruments or other offsetting instruments. For example, a put option obligates the writer to purchase the "underlying" on exercise. Therefore, a mutual fund may write a put option only if the fund either covers the position (*e.g.*, sells short the "underlying" at a price no less than the option strike price) or segregates cash, U.S. government securities, or other high grade debt securities in an amount equal to the option strike price. *See, e.g.*, Investment Company Act Release No. 10666 (Apr. 18, 1979) [44 FR 25128 (Apr. 27, 1994)]; Dreyfus Strategic Investing (pub. avail. June 22, 1987).

[52] Section 18 was originally designed primarily to address the leverage created by the issuance of public senior securities, such as bonds or preferred stock. *See, e.g., Senate Hearings, supra* note 50, at 265-75 (1940).

[53] *See* Remarks of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the Investment Company Institute Annual Conference in Washington, D.C. (May 18, 1994).

[54] These instruments include capped floaters (whose floating rates will not adjust above a stated level), CMT floaters (whose floating rates are tied to longer term rates and which will not return to par if the relationship between short- and long-term rates changes), leveraged floaters (whose floating rates move at multiples of market interest rate changes), dual index floaters (whose interest rates are tied to two indexes and which will not return to par if the relationship between the two indexes changes), and COFI floaters (whose floating rates are tied to the Cost of Funds Index, representing the cost of funds to thrift institutions in the Eleventh Federal Home Loan Bank District, which substantially lags market rates).

[55] Investment Company Act Rel. No. 19959 (Dec. 17, 1993) [58 FR 68585, 68601-02 (Dec. 28, 1993)]. Rule 2a-7 allows the maturity of adjustable rate instruments to be determined by reference to interest rate adjustment dates if the instrument "can reasonably be expected to have a market value that approximates its par value" upon adjustment of the interest rate. The proposed rule would clarify that the board of directors or its delegate must have a reasonable expectation that, upon adjustment of an instrument's interest rate at any time until the final maturity of the instrument or until the principal amount can be recovered through demand, the instrument will return to or maintain its par value.

[56] Letters from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to chief executive officers of 50 largest mutual fund complexes (June 16, 1994).

[57] Letter from Barry P. Barbash, Director, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (June 30, 1994).

Adoption of the Commission's proposed rule 2a-7 amendments and the guidance that the staff and I have given should provide additional protection for money market fund investors. No rule text, however, can anticipate events that may result in a fund's net asset value falling below $1.00. To date, a number of sponsors or advisers of money market funds with positions in the types of adjustable rate securities identified in the Commission's December 1993 proposal have taken actions to cause the net asset values of those funds not to fall below $1.00. The Commission believes that the potential continues to exist that a sponsor or adviser of a fund holding these or other types of adjustable rate instruments that pose similar risks will be unable or unwilling to take similar actions, and that the net asset value of such a fund will fall below $1.00.

The Commission will continue to be vigilant in enforcing compliance with all provisions of rule 2a-7. In addition, we will persist in our efforts to impress upon investors that money market funds are not insured or guaranteed.

Through its inspection process, the Commission can and does monitor fund policies and portfolios, including derivatives activities. Generally, the Commission inspection staff can obtain complete information concerning the purchase and sale of portfolio instruments, detailed information concerning each portfolio instrument (including information concerning the valuation of portfolio instruments), and information relating to fund risk monitoring and fund portfolio strategies. The Investment Company Act requires funds to maintain and provide to the Commission records reflecting much of this information.[58] Generally, funds voluntarily provide the Commission staff with additional documents and access to fund personnel to facilitate the inspection process.

The recordkeeping, reporting, and inspections provisions of the Investment Company Act, however, impose some limits on the Commission's authority to obtain information required to monitor mutual funds. In practice, these limits often do not hinder the Commission's fulfillment of its responsibilities, but they may do so in some circumstances, including, for example, when a fund does not voluntarily cooperate with the Commission; when, in times of market stress, rapid access to fund information is important; when the unavailability of electronic records in a format usable by the Commission interferes with an efficient inspection; or when a fund does not maintain records that, if available, would improve Commission understanding of the fund's operations. The Commission intends to seek legislative clarification and expansion of its existing recordkeeping, reporting, and inspections authority. I will now discuss this recommended legislation in more detail.

First, as a general matter, the Commission currently may require funds to keep records forming the basis for the preparation of financial statements.[59] The Commission recommends amending the Investment Company Act to authorize the Commission to require funds to keep records "necessary or appropriate in the public interest or for the protection of investors." This is the same grant of recordkeeping authority that Congress has provided to the Commission with respect to broker-dealers and investment advisers.[60] Second, the Investment Company Act's recordkeeping provisions do not specifically address the medium in which records are required to be kept. The Commission would like specific authority to require that fund records be kept in an electronic medium.[61] The Commission recommends amending the Investment Company Act to specifically authorize the Commission to specify the medium and format in which records must be kept, including electronic media.

Third, under section 31(b) of the Investment Company Act, there currently is no explicit requirement that funds provide the Commission records that are not required to be maintained under a specific provision of the Investment Company Act or Commission rules. The recommended legislation would amend the Investment Company Act to require explicitly that funds provide the Commission with all records that are kept by a fund, whether or not required by Commission rule to be kept.[62] Fourth, the Commission is authorized to require reporting by funds no more

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[58] Section 31(a) of the Investment Company Act requires every registered investment company to maintain and preserve those accounts, books, and other documents that constitute the basis for their financial statements. 15 U.S.C. §80a-30(a). Section 31(b) of the Investment Company Act provides that investment company records required to be maintained under section 31(a) are subject to examination by the Commission. 15 U.S.C. §80a-30(b).

[59] Investment Company Act §31(a).

[60] *See* Exchange Act §17(a)(1), 15 U.S.C. §78q(a)(1) (broker-dealers); Investment Advisers Act of 1940 §204, 15 U.S.C. §80b-4 (investment advisers).

[61] In 1986, the Commission amended rule 31a-2 to permit investment companies to maintain their records electronically. *See* 17 C.F.R. §270.31a-2(f)(ii).

[62] *Cf.* Exchange Act §17(b), 15 U.S.C. §78q (making all records of broker-dealers subject to Commission examination); 12 U.S.C. §248 (authorizing the Board of Governors of the Federal

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frequently than quarterly.[63] The recommended legislation would amend the Investment Company Act to authorize the Commission to specify the frequency of reporting by funds. This authority would, for example, assist the Commission in its oversight of the fund industry by providing more timely access to information on fund portfolios and sales and redemption activity in times of market stress.[64]

The Commission's ability to monitor the fund industry is constrained not only by statutory limits on the Commission's access to relevant information, but principally by limits on the resources available to hire the necessary personnel. The increasing use of derivatives and other complex portfolio strategies has heightened the Commission's need to hire, train, and retain a highly skilled mutual fund inspection force.

The Commission has acted, and will continue to act, to enhance investor protection in the area of mutual fund derivative investments. In the first instance, however, responsibility for managing a mutual fund's derivative investments falls on the fund's management and board of directors.

Adequate risk management systems are critical to a mutual fund's ability to monitor the risks associated with derivatives. Adequate management controls also are important to accurate pricing of derivative instruments, which may, on occasion, be a difficult task. The Commission staff has found, during inspections, that a number of funds appear to have strong risk management systems and other management controls in place, but we remain concerned that these funds may not be fully representative of the industry. We will continue to inspect funds' management controls and will consider rulemaking, as appropriate, to encourage better management controls.

I have urged fund directors to exercise meaningful oversight of fund derivative investments, involving themselves in portfolio strategies, risk management, disclosure and pricing issues, accounting questions, and internal controls.[65] While the Commission's resources are sufficient to permit it to scrutinize the derivatives activities of individual mutual funds on only a periodic basis, the directors of each fund are well-positioned and obligated to protect the interests of the fund's shareholders on an ongoing basis.

As reflected in my testimony, the use of derivatives in portfolio management of funds and personal investing by fund insiders are issues on which the Commission has spent and will spend considerable time and attention. I am quite sure other questions will arise from time to time on which the Commission will need to focus. I believe it is important, though, for the Commission not only to react to issues as they arise, but also to chart a course to follow in fulfilling our regulatory responsibilities. I want to conclude my testimony today by outlining the course we hope to follow in the coming months.

Investor Education—Investors should be educated about fund operations and, more generally, the risks and rewards of investing. The Commission will continue to devote resources to investor research initiatives designed to allow us to better understand the needs of investors, and to develop educational materials intended to meet those needs. We also hope to initiate novel outreach programs. Such programs may include participation of Commission staff in the preparation of educational materials relating to mutual funds for employee benefit plan participants and beneficiaries, and for high school and college students.

In the area of disclosure, the Commission will accelerate its efforts to develop rules designed to present investors with clear and comprehensible information on the key elements of fund investing—the objectives, the costs, the rewards, and the risks. The Commission also will work with the fund industry to make, on a voluntary basis, communications comprehensible and more useful to investors.

Fund Industry Responsibilities—The Commission will continue to communicate to fund managers and fund boards of directors the need to fully understand novel investment products prior to their use, as well as the need to clearly explain the risks of these products to investors.

We will continue to work with the fund industry to ensure that good sales practices in particular, and compliance matters generally, are deemed to be essential

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Reserve System to "examine at its discretion the accounts, books, and affairs of each Federal reserve bank and of each member bank and to require such statements and reports as it may deem necessary"); 12 U.S.C. § 481 (authorizing Comptroller of the Currency to appoint bank examiners who "have power to make a thorough examination of all the affairs of" national banks).

[63] Investment Company Act § 30(b), 15 U.S.C. § 80a-29(b).

[64] *Cf.* Exchange Act § 17(h)(2), 15 U.S.C. § 78q(h)(2) (authorizing the Commission, in times of adverse market conditions, to require registered broker-dealers to make reports concerning the financial and securities activities of their associated persons).

[65] Levitt Remarks, Directors as Advocates, *supra* note 15; Levitt Remarks, Mutual Fund Directors, *supra* note 16.

elements of the fund business, and not simply afterthoughts. The Commission's inspection staff will be encouraged not only to uncover deficiencies in compliance with the technical rules of the Investment Company Act and the other federal securities laws, but also to work with fund managers to develop compliance systems and practices designed to better protect investors.

Ethical Standards—The Commission will continue to emphasize the need for high ethical standards in the investment management business. We will be supportive of the efforts of private groups in articulating those standards.

In working to achieve these goals, the Commission will continue to seek to identify ways in which it can serve investors, rather than simply reacting to consumer problems as they occur. We will work with the fund industry to achieve high ethical standards and better serve investors. We will consult with consumer groups in attempting to define investor needs. Finally, we will coordinate our regulatory efforts with our fellow federal and state regulators, as coordination will best serve the interests of fund consumers.

From the beginning of my tenure, I have identified improving the oversight of mutual funds as a priority for the Commission. In the coming months, we will maintain our focus on traditional investor protection issues, while also working to implement a more consumer-oriented program. This dual focus will make the Commission more responsive to the investors it serves.

The Commission will not be able to achieve these goals or fully carry out its regulatory responsibilities without adequate funding for the oversight of the fund industry. The Commission greatly appreciates the Subcommittee's efforts to obtain adequate funding for the Commission. It cannot be emphasized too strongly, however, that more resources are needed for the increasingly important task of overseeing the mutual fund industry.[66]

I appreciate the opportunity to testify about these important issues affecting the investment company industry and to emphasize that investors will continue to have confidence in the industry only if it operates free of abuse and fraud and its ethical standards are beyond reproach. As the Commission addresses issues regarding investment companies, we will consider carefully the views of the members of this subcommittee and all of Congress, investors, the industry, and other interested parties. I would be happy to answer any questions you may have.

Mr. MARKEY. Thank you, Mr. Chairman, very much.

Now I will recognize myself for a first round of questions.

Perhaps you could tell us a little bit more about this money market fund that has so exquisitely timed its fall from grace so you could appear before us almost immediately thereafter; you noted, for example, that only institutional investors were involved. Do you know if the institutions were investing their own capital, or were they acting as fiduciaries for individual investors?

Mr. LEVITT. As I understand it, the institution, Community Bankers US Government Money Market Fund, which is a small money market fund, advised the Commission, as I said, yesterday, that it was going to liquidate. It is owned by a group of banks, and the fund now has approximately $83 million in assets and about 112 shareholders. Just about all of those shareholders are institutional investors, banks or bank holding companies. About 43 percent of the fund's assets consists of adjustable rate securities of the type that the Commission and the staff have expressed concern about.

In response to your question, no, individuals were not involved. There is one non-bank institutional investor in the fund, and the banks investors were not investing individuals' funds.

Mr. MARKEY. So how much capital would have been required for the fund to avoid breaking a dollar, do you know?

Mr. LEVITT. I am sorry, would you——

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[66] *See Hearing Concerning the Investment Company Industry Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs*, 103d Cong., 1st Sess. (1993) (statement of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission).

Mr. MARKEY. How much capital would have been required for the fund to avoid breaking a dollar?

Mr. LEVITT. Approximately $2 million. The fund money was not fiduciary money, these were the banks' own assets.

Mr. MARKEY. Based on your description, I am assuming that this fund did not break a buck just because of bad luck.

Mr. LEVITT. No.

Mr. MARKEY. Can you tell us about the derivatives that you think were the source of the problem?

Mr. LEVITT. Well, the securities that were held by this institution, by this fund, were floating rate government securities issued by the Federal Home Loan Bank, Sallie Mae, Fannie Mae. On the face of it, these sound like the safest securities in the world. But the movement of these securities triggered by changes in interest rates—and the fact that these securities did not float with short-term rates when they went up—created the kinds of problems that we see derivative instruments creating. We have been watching this fund and have been aware of their problems since the end of July. We have been talking to them almost daily, monitoring them to see whether they could get out of their problems.

Mr. MARKEY. Were they appropriate holdings for a money market fund?

Mr. LEVITT. Probably not.

Mr. MARKEY. If not, would you consider enforcement actions against the managers or the directors of the fund?

Mr. LEVITT. It is the practice of the Commission not to discuss enforcement activities. Let me respond to that by saying that we are looking very closely at the activities of the fund to determine the answers to questions.

Mr. MARKEY. Can you describe for us how the liquidation is likely to proceed? Will the Commission actively monitor it?

Mr. LEVITT. The Commission will actively monitor it. I understand that advisories have gone out to the 112 shareholders in the fund advising them that distributions will be made within the next several days.

Mr. MARKEY. Is it fair to characterize the situation as isolated or unusual?

Mr. LEVITT. There have been very few instances of funds breaking a dollar, liquidations of this kind.

Mr. MARKEY. So it would be fair to characterize it that way?

Mr. LEVITT. I would say that it would be fair to characterize this as isolated. I would submit the caveat that obviously we are monitoring this very closely to determine whether there are other instances of this kind that we should be aware of.

Mr. MARKEY. My time has expired.

I recognize the gentleman from North Carolina, Mr. McMillan, for a round of questions.

Mr. MCMILLAN. Thank you, Mr. Chairman and Chairman Levitt, for coming back up again to help us with this issue. I, of course, want to study the recommendations that you have alluded to with some care. I haven't had a chance to read them. So I suppose my question this morning might focus, if we can, a little bit on the Community Banker's Mutual Fund as the Chairman of the committee did. I don't know that you have had a chance to look at that,

but could you perhaps offer some suggestions as to how that particular situation might not have occurred had the recommendations that you're pursuing been in effect?

Mr. LEVITT. Well, obviously with the development of the use of derivative instruments that is taking place in our marketplace, the Commission has given very careful thought as to how we can obviate the kinds of occurrences that took place yesterday. And I think one of the most important things that we are endeavoring to do is establish of a quantitative risk measure in fund prospectuses.

The major problem I believe that America's investors have today with respect to derivative usage is a lack of understanding. Some derivatives really diminish risk and they are a very appropriate investment. In some instances, because they are stretching for competitive advantage in terms of offering a higher rate of return than their competition or because of inadequate understanding of the impact that a derivatives instrument can have, funds are using derivatives in a way that investors really do not understand.

I think as long as a fund conveys the level of risk that is entailed in a particular strategy that is well and fine. As long as they can define that to investors, I think that is appropriate. What concerns me most is a fund that is inadequate in its definition of risk and investors who, not knowing any better, buy a fund that has a name that suggests safety and security, yet engages in practices that are very aggressive and dangerous.

We are also going to consider whether to reduce the ceiling on fund illiquid holdings. We are going to take a look at the leverage restrictions of the Investment Company Act as they apply to derivative investments. And we are going to recommend that Congress enact legislation to extend the Commission's ability to obtain information required to monitor fund derivatives use through fund recordkeeping and reporting requirements and Commission inspections.

I think that while what occurred yesterday harms no individual investors, I think it serves as an alert, as a warning of the steps that have to be taken between the industry and the Commission to protect investors who have invested in funds and do not expect the kinds of risk levels that they may be encountering.

Mr. MCMILLAN. It seems that this really has to do with the fact that people who should know better are not paying attention to what they are getting into. This is a case of supposedly highly sophisticated investors limited to, I think 150, investing in what was presumed to be a highly sophisticated investment pool, and something broke down here. I haven't had a chance to look over the nature of the assets that they were in, but clearly they were illiquid. What the level of risk was is difficult for me to determine at this point. But if people in that position aren't going to look at the risks that they are exposing themselves to, are you suggesting that we are going to create some independent panel that will appraise these riskings and put a rating on them?

Mr. LEVITT. No. With respect to this particular event, I have to assume that these were relatively sophisticated investors who did have some appreciation of the risks that were involved and they are paying the price for it. I am much less concerned about that than I would be about a fund that involved hundreds of thousands

of individual investors who bought a fund that had a name that suggested safety and security and yet engaged in investment practices that were terribly aggressive and misleading.

I think the Commission is concerned about that, and we are going to use our existing rule, which is 2a-7, to limit money market funds to low-risk investments with respect to individual investors. But I don't think there is anything the Congress or the Commission or any group can do to protect investors against themselves. There is an amount of care and caution and learning that every investor must exercise and it is because of that that the Commission over the course of coming months and years is going to spend so much time dealing directly with investors to try to acquaint them with risk levels.

As far as the establishment of a guide with respect to risk, I couldn't think of a panel that could possibly come up with such a recommendation. I think what we are working with are certain statistical standards to be able to distinguish fund "A" from fund "B" on some sort of risk continuum, so that an investor can look at fund "A" and say, you know, the return is 30 basis points higher than the average return of money market funds, and because of that there is a risk level that is somewhat higher than average.

If I am prepared to take that risk, I will do so with my eyes open. If we can come up with a formula that would acquaint investors with the fact that there are different risk levels, I think we will have done more to address the issue that we are talking about now than any cluster of panels or rules or regulations or anything else, and it is part of a process of disclosure that, in my judgment, is the greatest response to any of the problems that we face in our securities markets.

Mr. McMILLAN. You mentioned in your testimony efforts to encourage independent directors to be more aggressive or assertive in exercising their responsibilities. I know we have had testimony before this committee with respect to so-called independent directors on corporate boards, and differences of opinion about that. Have you thought much further or would you care to be more specific about how you would perhaps recommend that this be implemented in the case of mutual funds?

Mr. LEVITT. Yes, I have. I have personally served on nine corporate boards and countless philanthropic boards, have some notion as to the responsibility of boards, of how they are appointed, how they function. I think that the independent directors of the mutual fund have a very special responsibility in terms of protecting the public interest, protecting investors who have an imprecise view of risk levels involved in their investment. In many respects, I believe those boards are in the front line of protection, of seeing to it that the funds meet their ethical commitments to those investors, of seeing to it that there is a greater level of understanding about risk and strategies and practices, and I guess overall of seeing to it that the code of conduct embraced by mutual funds, which I think is so fundamental to the activity of mutual funds in the United States today, encompasses the highest possible standards. The directors should be evaluated in the same way as management is evaluated. A nominating committee should consider directors' performance and replace directors who are unable to give the time

and attention to their responsibilities, the same way any corporate directors should be held responsible.

Directors should ask the tough questions. I think that if there is a standard that I would impose upon directors as a result of my experience, I would say the best directors are the ones able to ask the most provocative questions. And the poorest directors, generally speaking, are the quietest directors. That is not to say that directors shouldn't work in a manner of consensus with management. I am not suggesting an adversarial role. I am suggesting an independent role. The name "independent" is well conceived. The independent directors should feel free to challenge management and to understand policies, and if they are unable to understand the investment policy embraced by managements of mutual funds, I believe those policies are wrong.

So I think these are the standards that I have suggested to directors. They are the standards that I intend to discuss with them when I meet with them individually, as will my fellow Commissioners, and we intend to do this on a very extensive basis.

Mr. McMillan. I think that is an important point, if not a rather difficult one to implement, so I will be interested as we further develop this as to how we can go about achieving that and what is otherwise a democratic process, somewhat democratic process of selecting directors.

Mr. Levitt. We have recommended that a majority of independent directors be chosen for fund boards. Right now, the requirement is only 40 percent. I think that majority is something that the best funds are moving towards, and I hope that best practice will be embraced by other funds.

Mr. McMillan. Let me pursue one point that we have touched on previously having to do with the recommendations of changing from the current SEC practice requiring disclosure about the characteristics of individual derivatives to disclosure about the fund portfolio as a whole. The argument is this would avoid the problem of misleading investors by detailing a particularly risky investment that on a portfolio basis might be balanced out by something else.

How would portfolio-wide disclosure allow people to evaluate the benefit of nonperformance by a counterparty or how could someone determine if there was an overconcentration of transactions with one particular counterparty? Won't that require some kind of derivative-by-derivative approach?

Mr. Levitt. I think that is very difficult and complex. I think that kind of disclosure can be useful for those analysts such as Morningstar and Value Line and others who follow and interpret mutual funds' risk level, that might be a useful discipline. I would be interested to hear further views from the analysts on that score.

But I think that we have got to be a good deal more direct and a good deal simpler in terms of coming up with a risk appraisal. Merely a blizzard of statistics in terms of portfolio holdings is not the answer, in my judgment. It is part of the process of understanding. But my concern with this, together with the overall level of what goes into a prospectus, which I know the Chairman is concerned with, is a level of confusion. In our effort to disclose, we have very often confused, and I think our efforts should be directed

towards focus and distillation rather than towards just an abundance of statistics.

Mr. MCMILLAN. I think, Mr. Chairman, I have no further questions at this point.

Are we going to come back around?

Mr. MARKEY. Yes, we will.

The time of the gentleman has expired.

The Chair will recognize himself for a round of questions.

Chairman Levitt, I would like to read you a quote from an article in this week's Barrons, a copy of which we have included in the record. Two experienced money managers who have consistently shunned derivatives in recent years were interviewed. One commented as follows:

"One of our real concerns is that the derivatives crisis is going to get worse. We are starting to see evidence that many smaller, less sophisticated accounts have derivatives exposure and are much less capable of handling the losses. In fact, they are just now discovering the degree of their problems, which is going to make it worse. While in size these problem portfolio's aren't as large as Paine Webber's or Piper Jaffray's in terms of range and in terms of their potential for damage to the investors involved, they are probably more significant."

This is but one of the many sobering comments, Mr. Chairman, that continue to come to the public's attention and this subcommittee's attention, though it is not clear that they are all centered upon mutual fund investments.

Could you share with us your thoughts on this analyst's observations and how concerned you are about the problems that may be developing?

Mr. LEVITT. Well, I think we have seen evidence of massive payments by some of the larger funds to make them whole and to avoid the kind of problem that developed yesterday with a substantially smaller fund. And I think the kind of publicity that has been attendant on that has certainly caught the attention of fund managements and fund boards. So I think a great deal of care and introspection is going into the process of running these funds.

I think from the investor's point of view the attention has also been very useful, because I think investors are not willy-nilly buying funds merely because they are called money market funds. They, together with you, have performed a useful public service in calling attention to the fact that there are money market funds and money market funds. It wouldn't surprise me to see other funds come up with problems created by derivatives. I believe that most of this will probably occur with some of the smaller funds. We are looking very carefully and closely at it.

But my long-winded answer to your question is there probably are more problems out there. Do I think it represents a serious systemic risk which will drive millions of mutual fund investors out of the market? No, I do not. I believe that all of us are handling this responsibly and I believe that the public is being adequately protected.

Mr. MARKEY. Let me then return to the money market mutual funds for a moment. Could you describe for us the general purpose

of rule 2a-7, the Commission's rule limiting certain investments by money market funds?

Mr. LEVITT. Yes. 2a-7 is designed to limit money market funds to investing in short-term, high-quality securities that have a low level of volatility.

Mr. MARKEY. I am of the understanding that about $700 billion has been invested in money market mutual funds by Americans, and I believe that many of them view these funds as a slightly higher yielding version of a bank checking account. They achieve the higher yield by voluntarily forfeiting the protection afforded by deposit insurance. Now, notwithstanding the absence of insurance, many of these investors still appear to view their money market funds as extremely safe investments principally because they believe these funds invest only in very high-quality, short-term obligations.

How do we square this expectation with the fact that some money market funds have made significant investments in exotic derivatives, and are such investments possible under Rule 2a-7?

MR. LEVITT. Rule 2a-7, as you point out, has been responsible for the tremendous growth in money market funds. I think that the industry has become so competitive, yield has become the all important factor in terms of why fund "A" believes it is better suited to investors than fund "B" or "C," and in striving for that competitive advantage some funds have used derivative instruments that I believe they inadequately understood.

Derivatives are a relatively new phenomenon and I think the mistakes of the past generally are not being repeated over and over again. But unquestionably, some funds have used derivatives in a way that has been costly to the funds. But I don't agree, or I don't believe that the funds have made such extensive use of exotic derivative products that the viability of a large number of funds is in jeopardy. I think it has cost some funds money and their managements have replaced those funds. But I don't believe that there is a systemic problem in that connection.

We are very closely looking at funds and we will certainly bring actions against those managements that have paid inadequate attention to the risk factor involved in using derivatives that really were inappropriate. When we talk about an exotic derivative, I don't personally believe any funds, any money market funds should be using a derivative product that we could construe as being exotic. If they do, I would encourage the Commission to come down and come down hard on them.

Mr. MARKEY. Is there a way of communicating that——

Mr. LEVITT. Yes.

Mr. MARKEY. [continuing] more formally to each of the fund managers in the country so that they know the distinction and can properly modify their money market mutual funds to reflect what you believe to be a reasonable interpretation of the more limited risk profile that a money market mutual fund should have?

Mr. LEVITT. When we considered the fact that money market funds were beginning to use products that bordered on the exotic and in some cases spilled over to the exotic, I took the rather extraordinary step of personally writing to the heads of all 80 of the

major fund complexes. To the best of my knowledge, that had never been done before.

I wanted to put them on notice that this is something we care about, we are looking at, and we will not tolerate. I have spoken about it to directors of funds. I have asked my fellow Commissioners to step up their individual approaches to independent directors of mutual funds, and the Division of Investment Management has sent similar communications to the funds alerting them to what we consider to be an important responsibility.

Mr. MARKEY. Now, did any of those fund managers correspond with you in a way that would indicate their rejection of the premise?

Mr. LEVITT. To the best of my recollection, not one of them did.

Mr. MARKEY. Okay. That is helpful. Well, that should give some confidence then to people who are in the money market mutual fund area as investors, if there seems to be industry-wide acceptance of your warning to them that exotic derivatives are inappropriate.

Mr. LEVITT. I think it does, but I think it is really a continuing process. My experience in this industry recalls the premium placed on innovation and creativity, and there will be new products, new kinds of derivatives, and we cannot relieve the investor of some measure of responsibility of learning about what he is doing and protecting himself, but we have got to stay on top of it.

Mr. MARKEY. Well, let's move on then to that subject of innovation. Mr. Fields and I wrote to you in June and expressed concern that competition for assets in the fund industry might be becoming so intense that it might be causing otherwise conservative funds to take on disproportionate risks in order to outperform rivals and in order to achieve high rankings.

What is your assessment of competition in the fund industry and what some describe as the desperate chase for yields?

Mr. LEVITT. Well, I think it is fierce. I think you put your finger on something that really motivates the stretch factor. What I call the stretch factor is, in order to deliver what has become the standard in terms of consumer acceptance of a given fund, relates to the use of instruments that bear different levels of risk.

Now, I don't object to a fund using an instrument that may have a level of risk that is somewhat greater than another fund as long as that is clearly defined as far as the investor is concerned, and the spectrum from money market funds, as far as I am concerned, is very, very narrow. Rule 2a-7 is pretty explicit in terms of what a money market fund can do or not do, yet it gives some measure of latitude to fund managements. I think that managements have to extend themselves in terms of suggesting why—if there is a 30 basis point differential between their fund and the average level of money market funds—they have a responsibility of explaining that there is a concomitant level of risk incurred in order to obtain that 30 basis point advantage.

Mr. MARKEY. Now, are there regulatory incentives that are being provided to the marketplace?

Mr. LEVITT. I think so.

Mr. MARKEY. And what are those regulatory incentives?

Mr. LEVITT. That we will not tolerate the use by funds of inappropriate products, inappropriate strategies, any variation from the restrictions imposed by Rule 2a-7.

Mr. MARKEY. Well, let's think then about the significant problems experienced by Paine Webber and Piper Jaffray, funds with almost $1 billion in losses between them. Is there a moral to this sad and costly story for investors?

Mr. LEVITT. I think so, and it is an important moral in light of the large number of investors who have made their first investments in mutual funds. It is that any fund can lose money. What is most important, regardless of the market environment, is that every investor in a mutual fund understand that he or she is investing in securities that carry market risks. Funds fall into a wide range, with some being more risky than others. For example, generally speaking, funds primarily investing in small cap stocks or emerging markets carry greater risk than funds that invest in Treasuries. Even within one type of fund, different portfolios will have different levels of risk. I guess the key moral again is that any fund can lose money.

Mr. MARKEY. I understand that the Commission has been preparing for some time now a new brochure for the use of mutual fund investors. Could you tell us about the contents of the brochure, what its goals are, how you expect to make it available to investors?

Mr. LEVITT. This is part of a bottoms-up process that the Commission is embarking upon—of meeting with thousands and thousands of investors all over the country, of explaining to them the variety of investment vehicles that are available to them, and what to look out for, what to be concerned about. This is the second brochure in a series.

The first covered the broad spectrum of investments, and this one deals with mutual funds. It tells investors about different kinds of funds and what factors determine whether a fund makes money or doesn't make money. It stresses the cost factors in a fund. It stresses the risks of investing in a fund. What it does really, it is intended to educate investors to the opportunities and risks involved in investing in mutual funds.

The original brochure has been sent to tens of thousands of people all over the country. In that case, we worked closely with the SROs in distributing it, and every day the Commission sends out nimerous copies to investors.

We intend to have the initial distribution of the mutual fund brochure made through various investing groups that we have talked to. We have talked to AARP, and they have arranged for meetings with investors all over the country where this brochure will be distributed. We are talking to some of the brokerage firms and the SROs about distributing it.

We hope to secure public service advertising to call the attention of the public to it and distribute it directly ourselves. We regard this as a very important step of public education.

Mr. MARKEY. Well, and what about derivatives? What do you say about derivatives in the brochure?

Mr. LEVITT. We talk about derivatives and what their implications are in terms of fund performance. We tell investors to be

careful about derivatives and to ask the tough questions—whether derivatives are being used and whether they are hedging devices or are being used for more speculative purposes.

Mr. MARKEY. Well, let me try to wrap up because I want to recognize the gentleman from North Carolina again, but would the Commission consider extending the limits contained in Rule 2a-7 to short-term government bond funds?

These are the most conservative and cautious bond funds, and those qualities frequently form the basis of a fund's marketing efforts to potential investors, like the money market mutual funds. There is a preconception in the minds of ordinary investors that these are safe, that these are limited risk, and when they are loaded up with exotic derivatives, the personality of them clearly changes without any real understanding on the part of the investors that they may see precipitous drops. But in an effort to keep pace with the promises that are made in newspaper advertisements with regard to the success of these funds, they are driven across a line and into misadvertising something that is much more dangerous in terms of its potential side effects.

Should Rule 2a-7, in your opinion, be modified—should we stretch the regulatory process to capture the stretch that exists in many of these funds?

Mr. LEVITT. If the Commission's increased emphasis on investor awareness, on consumer understanding of what is involved is successful, I hope we will be able to define the very subtle difference between a money market fund and a short-term fund. Both of them obviously represent on the continuum of risk the lower end of risk parameters, but a short-term fund, almost by definition, implies a modest level of increased risk over a money market fund.

The danger in extending Rule 2a-7 is how far should that go? Because then we could extend it to the next mutual fund, and I think the kind of restrictions that are imposed by Rule 2a-7 are so detailed and so specific that it would take away many of the opportunities that some of the really good short-term funds offer today.

I would much rather use the existing powers that the Commission has to look for the sorts of abuses that very rarely, but occasionally, come up in short-term funds and crack down on them hard. Obviously if we felt that our existing arsenal was inadequate and if our efforts working with the ICI and the industry did not produce results, then we would look for stronger medicine. But right now, I don't think I am prepared to call for that quite yet.

Mr. MARKEY. Well, I think that there have been large numbers of problem cases in that area, and we will be monitoring that as well just to make a determination as to whether or not we should begin consideration of that.

Let me turn and recognize again the gentleman from North Carolina.

Mr. MCMILLAN. Thank you, Mr. Chairman. Mr. Levitt, I wanted to just go back a little bit to the Community Bankers' Fund. They sent out a memorandum to their shareholders apparently yesterday in which they offered to exchange to their shareholders, in lieu of cash, a list of securities which describe at par value some $35.5 million of the fund's stated assets. Out of what proportion of the

total fund that is, it doesn't say in the memorandum, and I think you mentioned a figure of——

Mr. LEVITT. $83 million.

Mr. MCMILLAN. $83 million. Is that a current valuation of——

Mr. LEVITT. I think so, yes.

Mr. MCMILLAN. So it is not quite up to 50 percent. If these are illiquid, I am assuming that there must be some degree of illiquidity to these or else they wouldn't be offering them to shareholders in exchange—in lieu of cash in liquidation.

Is that an accurate presumption?

Mr. LEVITT. I am not familiar with all of the details of the distribution. I believe that the fund was prepared to offer a cash liquidation. Let me verify that.

What I am told is that since so much of the fund is illiquid, but a good deal of it can be liquidated and a liquidation at this point would result in a recovery of something like 94 cents on the dollar, the loss amounts to about 6 percent.

Mr. MCMILLAN. I am not trying to put you on the spot on something that we both just got information; but I want to get at the Commission's response to the Markey/Fields letter that you are going to tighten up on liquidity standards where the funds are currently limited to 15 percent. I think you said you were going to propose reducing that to 10.

Mr. LEVITT. Yes.

Mr. MCMILLAN. In this particular case, although this wasn't a widely-held fund, we may be talking about percentages far in excess of either 10 or 15 percent.

Mr. LEVITT. What you are asking me is why limit it to 10 percent when maybe it should be limited to 5 percent or 2 percent?

Mr. MCMILLAN. Well, I guess I am also asking, if you go down this list of these securities, to the outside—I don't know who is sophisticated—these are all structured notes based on U.S. Government securities of one sort or another issued by highly regarded broker-dealers. The formulas bear some study.

I would have to spend a lot of time to understand what, in fact, I would own in these securities. Presumably, a high proportion of these are illiquid or they are only liquid at fractions of their stated value, which apparently is the problem. I am just curious as to how we are going to deal with this in terms of percentages of liquidity.

Mr. LEVITT. I don't—I think a liquidity percentage is only one of a series of measurements which one would consider in terms of dealing with this. With respect to money market funds, the liquidity level is already at 10 percent, but that is only a guide.

I think the greatest protection is a higher level of understanding on the part of boards and managements in terms of the direction they are taking and strategies that they are going to use, and I think that in the development of any new product, even when electricity was invented, a lot of people got burned and shocked, but it certainly has been a useful and powerful mechanism.

By the same token, I have every confidence that what we call a derivative today is going to be called something different 5 years from now. I'm not quite sure what, but it will be a more accepted part of the landscape. I think our job collectively is to see to it that too many people don't get hurt during the process and that a fair

measure of openness is involved so that neither managements are surprised, nor are investors surprised by the kinds of results that they get from a risk profile which hopefully they understand better than they do today.

Mr. McMillan. Trying to stick with this general issue of liquidity, if I were an independent director of this particular fund, I would question whether or not these securities became illiquid simply because of an upward movement in Federal Reserve rates.

That certainly might influence their value, but the issue of liquidity really troubles me on something like this. You know, I have been in the business, in the underwriting business, and got caught midstream with a moving interest rate by the Fed when you had a certain bond position and you can lose a lot of money in short order that way in what presumably is a riskless—what one would think a relatively low-risk transaction.

Mr. Levitt. Well, without studying all these instruments, I can suggest that they don't merely move in the same direction as the level of interest rates does. As a matter of fact, when they acquired these instruments, they were highly liquid.

Today, with the change in interest rates, they have become much less liquid. They are not—structured notes generally are not bread and butter products. They verge on the exotic, and because of that, this group of sophisticated investors, not public investors really, got somewhat burned.

I hope that that is a message that is heeded by funds and investors of funds that have a large amount of public participation, and maybe we will avoid some of the problems that were experienced here or have been experienced by such as the Paine Webbers.

Mr. McMillan. I thank the chairman and that concludes my questions.

Mr. Markey. The gentleman's time is expired, and I just have one final quick line of questions, if I could, and that is on personal trading special examination, Mr. Chairman.

I wonder if we can accurately distill the factual findings of the personal trading special examination that have been reached thus far. First, personal investment activity by portfolio managers was infrequent. Second, even among the relatively small number who traded much more actively, the type of trading activity that might raise suspicions was limited. Is this an accurate summary of the examination's overall findings?

Mr. Levitt. Yes, I think it is. I would stress the fact, Mr. Chairman, that we selected 30 fund complexes for this study. While I think that that gave us some interesting results, I would not say today that we can rest totally easy about this, and this is a moving target.

I think I said the last time we talked about this that if I were starting the Levitt Mutual Fund, I would not allow my managers to trade. I think it is just wrong for perceptual reasons, but I think that the industry trade association, the ICI, acted very responsibly by addressing this issue immediately and appointing a blue ribbon panel that recommended the kinds of restrictions on the most egregious examples of trading abuse to satisfy me and the Commission that this was the way to address the issue.

Now, it is our hope and our expectation that almost every mutual fund in the United States will embrace these recommendations. We are going to look at it again in a few months, and if they don't, believe me, we will be back there with a much stronger message because I think that this is fundamental to public perception of a very important market.

Mr. MARKEY. I think that the results are somewhat positive, and I am impressed with the overall findings of the report, but I would also be remiss if I did not qualify that conclusion.

The subcommittee fully expected that when measured in percentage terms, the overwhelming majority of funds and fund managers would be found to be acting in a manner perfectly consistent with both the letter and the spirit of the law.

Front running and other methods of intentionally manipulating mutual fund assets for the personal benefit of a portfolio manager or other insider are clearly violations of the securities laws.

Do you agree that we should be wary of drawing overbroad conclusions based on the perception that abusive personal trading is not prevalent at most funds?

Mr. LEVITT. Yes, I do.

Mr. MARKEY. Is the Commission prepared to share with us any information about those transactions that you have identified which may be potentially abusive? For example, have you identified any cases of front running?

Mr. LEVITT. As you know, the Commission has a practice of not discussing the details of its enforcement activities, but as we continue to work with the universe that we have surveyed, we will acquaint you and your staff with actions that we are about to take.

Mr. MARKEY. So you will report back to us when you have reached final conclusions with regard to the presence of front running?

Mr. LEVITT. Yes. Yes.

Mr. MARKEY. Thank you. And when do you expect that examination to be completed?

Mr. LEVITT. I would expect within the next 6 months.

Mr. MARKEY. And in examining for potential front running, will you also be looking for possible intermarket front running in which trades are done in both the cash and derivatives market?

Mr. LEVITT. Yes. I would say that an examination for front running is not a one-time project but something that is uppermost in the minds of our examiners as they go about their regular duty.

Mr. MARKEY. Thank you, Mr. Chairman, very much. Do you have any concluding statements to the subcommittee? Does the gentleman from North Carolina have any comments? We thank you, as usual, very much for excellent testimony, and we will move to our second panel.

We now turn to our second panel that is extremely distinguished, and we begin by recognizing Hon. G. Oliver Koppell, who is the attorney general of the State of New York. His tenure has been distinguished by a significant interest in consumer protection issues which is evidenced by his office's vigorous oversight of those mutual funds that do business in New York.

I welcome you to the subcommittee, Mr. Attorney General. Whenever you are ready, please begin.

STATEMENTS OF G. OLIVER KOPPELL, ATTORNEY GENERAL, STATE OF NEW YORK; DON PHILLIPS, PUBLISHER, MORNINGSTAR, INC.; AND MATTHEW FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. KOPPELL. Thank you, Mr. Chairman, and members, who I guess are not right here, but members who will be reading this as well as staff and counsel. I thank you for the opportunity to address you.

Mr. MARKEY. If I may, Mr. Attorney General, there are 380 Republican Members of Congress standing on the steps of the Capitol right now to sign their "Contract with America," and they are completely unavailable for this hearing. I had a few unanimous consent requests I was going to make that I have been waiting several years to get in, but all right. Maybe the opportunity will arise again. I apologize for interrupting.

Mr. KOPPELL. I spent many years in the legislature, Mr. Chairman, and was chairman of several committees and very often was the only person sitting in hearings, so I am familiar with the position you are in.

As you indicated, my office is charged with protecting the investing public by enforcing New York's investor and consumer protection acts. We have been quite active in reviewing mutual fund investments with the aim of protecting New York mutual fund buyers and investors, and you know we have been in correspondence with you as well as with Mr. Levitt and the SEC on these concerns.

We are very concerned, Mr. Chairman and members, over the use of derivative security products in mutual funds. Earlier this year, my office resolved a case in which a tax exempt bond fund portrayed itself as a vehicle for safety conscious investors when, in fact, the fund employed leveraging techniques, including 40 percent allocation of the fund to inverse floaters, and we entered into an agreement in which their marketing literature would be substantially changed and they would market their product substantially differently, giving consumers some indication of the risks that they were entering into.

We are also currently well advanced in investigations of several mortgage-backed securities funds that purchased hundreds of millions of dollars of volatile CMO inverse floaters. We are investigating the extent to which false and misleading statements about the safety, stability, and risk profile of these funds were made to the public.

We know, as was mentioned in the earlier testimony in some of the back and forth, that there is tremendous pressure on mutual funds to distinguish themselves from others and to show higher yields. By purchasing inverse floaters, structured notes and other instruments with indebted leverage characteristics, funds receive income and experience price changes that are greater, I might say far greater, than if the fund had invested an equivalent sum in a conventional product with the same maturity.

The difference in performance that results from the use of such leverage must be recognized for what it is, and that is speculation, and the big problem I think, Mr. Chairman, is that traditionally many types of mutual funds were seen as nonspeculative because they invested in high-credit securities, and while these funds are

still designated or still viewed as nonspeculative and still invest in some sense in high-credit securities, the interest rate risks that they take, particularly because they are leveraged risks, make these highly speculative investments, even though they look like the old plain vanilla, high credit risk mutual funds.

By framing the issue in this way, I want to draw a distinction between the leveraging performance of derivatives and derivatives that are used as bona fide hedging vehicles or a mere substitute for an investment in a conventional security.

If properly managed and disclosed to investors, both of these latter investment techniques are, indeed, useful for management tools, and Mr. McMillan made reference to that, but there is a tremendous distinction between the purchase of derivatives for hedging purposes and the purchase of derivatives for leverage and income purposes.

And indeed, even when they use derivatives for hedging, we are aware that prominent, presumably sophisticated corporations have lost hundreds of millions of dollars, and in two instances, $1 billion each from improperly executed or supervised hedging activities.

Let me talk about some of the things we are involved in right now in New York. Our focus right now, as I said before, is on the mortgage income funds, where as much as 60 percent of portfolios have been invested in speculative derivatives. We have identified a number of funds with assets of over $3.5 billion whose share prices are on average down 20 percent in the first 8 months of this year.

In every instance, the magnitude of these losses relates to the use of exotic mortgage derivatives, primarily inverse floaters, principal-only strips and interest-only strips. The purchase of these funds were not speculators for the most part. Thousands of investors have been sold these funds based, it now appears, upon a misplaced emphasis by the sellers upon credit quality of securities issued by U.S. mortgage agencies while omitting disclosure of the speculative aspects of the CMO derivatives.

Here are some examples from our investigation, without mentioning names of companies. Representatives of one fund that has 25 percent of the fund invested in inverse floaters told our investigator last November, when he tried to find out on what basis these were being sold, that the fund was absolutely conservative, very low risk, and when asked what inverse floaters were, he was told, our investigator, that they were sort of like a stabilizer.

In a scripted presentation from a firm's internal road show for its own salesmen, the statement that, quote, "CD investors are looking for safety and competitive yields, features available in our fund."

CD investors are not looking for inverse floaters or derivatives. That is not consistent with their objectives.

From a story caption in a firm newsweekly, spotlight on our fund with—spotlight our fund with your maturing CD clients. I would like to show you one example of an advertisement from one particular fund, which we have copies of here which illustrates the problem. The headline on this ad says, "Investing for principal preservation doesn't have to mean settling for lower yields," and then if you read with respect to this particular product, it says,

"High monthly income from the highest credit quality securities consisting primarily of mortgage-backed and asset-backed securities and to a lesser extent zero coupon municipal securities."

This is a fund that sold hundreds of millions of dollars based on high-credit risk—I am sorry, low-credit risk. I don't necessarily disagree that there was low-credit risk in the very long term or in the 7-year maturity here, although even there there is question as to the credit risk, I want to caution, but there was certainly no low-credit risk if you look at the shorter term beyond the maturity.

And as I say, even with the maturity we have concerns, and there is no indication in this advertisement, although I am sure that in the prospectus there was probably some indication, there is no indication in this advertisement that derivatives were going to be used at all in this particular fund. This is a fund that sold over $500 million to investors, and is part of a group of funds that is substantially down in market value this year because interest rates went up.

Our investigations are—our investigations are also examining whether fund managers have acted prudently in purchasing these exotic securities. One fund officer and director recently testified in a proceeding conducted by my staff that he was not aware of the FFIEC high risk stress tests.

There are these high-risk stress tests which are applied to bank investments and which limit the amount that banks can invest in speculative or high-risk securities. This mutual fund manager saw reports that indicated that the percentage of his portfolio exceeded the test, but he said he didn't know what the test meant.

In another case my staff is investigating, well after a fund adviser was deeply committed to high-risk CMOs, an expert management information system firm found that the fund advisor lacked the critical systems necessary to support exotic mortgage-backed securities.

Let me now say what I think needs to be done because I think this is a matter of very substantial concern involving billions of dollars of investments by unsophisticated investors.

First of all, I think that the Investment Company Act must be examined with the goal of protecting investors from the hazards of leveraged investments.

Second, and this has been talked about by Mr. Levitt, a simplified means of giving investors a clear indication of the degree of a fund's risk must be found, either by the private sector or by the public sector. I think that serious consideration should be given, and I realize that this is a difficult proposal and there are arguments against it in terms of people's freedom of action, but I think serious consideration should be given to limiting the speculative use of derivatives in mutual funds offered for sale to the general public.

I also think that prompt enforcement action is necessary against fund advisors who have misled investors about their investments in derivatives or violated fund investment limitations. And in the State of New York, as I say, we are involved in examining some of these and suspect that unfortunately some enforcement action is necessary.

May I conclude? The increasing use of derivatives by mutual funds has significantly heightened the risk posed to small investors. It is essential that Federal law and regulation be amended to better protect unsophisticated investors and those unable to bear the potential losses created by the use of these instruments.

[The prepared statement of G. Oliver Koppell follows:]

PREPARED STATEMENT OF G. OLIVER KOPPELL, ATTORNEY GENERAL, STATE OF NEW YORK

Chairman Markey and Members of the Subcommittee: Thank you for the opportunity to address you. My name is G. Oliver Koppell. I am Attorney General of the State of New York. My office is charged with protecting the investing public by enforcing New York's investor and consumer protection acts. These statutes authorize the Attorney General to commence both civil and criminal actions against those responsible for fraudulent securities offerings. We also possess broad authority to prosecute deceptive advertising. With these tools my office has been attentive to the phenomenal growth in popularity of mutual funds among small investors and has become a leader in ensuring that mutual fund purchasers receive the protections which the law accords to them.

Today the mutual fund industry faces a number of significant challenges arising from their use of derivative securities products. Earlier this year my office resolved a case in which a tax-exempt bond fund portrayed itself as a vehicle for safety-conscious investors when, in fact, the fund employed leveraging techniques, including a 40% allocation of the fund to inverse floaters. We are now well advanced in investigations of several mortgage backed securities funds that purchased hundreds of millions of dollars of volatile CMO inverse floaters. We are investigating the extent to which false and misleading statements about the safety, stability, and risk profile of these funds were made to the public.

Informed by these efforts, and the well-publicized infusions of money that a number of mutual fund advisers have made to prop up money market and income funds, I would like to frame the issues as they now appear to me.

Has use of derivatives by mutual funds increased fund exposure to market risks, and potential rewards, beyond those occasioned by ownership of conventional equity and fixed income instruments? They certainly have.

Have mutual fund prospectuses, annual reports and sales materials fully informed investors of the fund's use of derivatives to magnify exposure to market fluctuations? Not in all instances.

Do mutual fund losses due to derivative instruments pose the threat of eroding public confidence in mutual funds, and hence the public's participation in our capital markets? Yes, they do.

In today's competitive mutual fund marketplace it has become increasingly important for a fund to distinguish itself from the pack. Derivative instruments present fund managers with this opportunity. By purchasing inverse floaters, structured notes and other instruments with embedded leverage characteristics, funds receive income and experience price changes that are greater than if the fund had invested an equivalent sum in a conventional product with the same maturity. The difference in performance that results from the use of such leverage must be recognized for what it is: speculation.

By framing the issue this way I wish to draw a distinction between leveraging performance and derivatives that are used as bona fide hedging vehicles or as a mere substitute for an investment in conventional securities. If properly managed and disclosed to investors both of these later investment techniques are useful management tools. Yet we are all aware that prominent, presumably sophisticated corporations have lost hundreds of millions of dollars, and in two instances a billion dollars, from improperly executed or supervised hedging activities. [Metallgesellschaft AG and Showa Shell Sekiyu KK, an affiliate of Royal Dutch Shell Group].

Moreover, funds have not limited themselves to mere hedging or investment substitution. Structured notes, that superficially resemble short term income instruments, are now being customized by fund managers and derivatives dealers. These instruments will increase funds' exposure to the risks that accompany shifts in interest rates, oil prices and other commodity prices. Thus far, we have not seen portfolio exposure to such products of greater than 10% and the SEC's policy on illiquid investments probably limits exposure to 15% of assets.

Our own enforcement focus is on the mortgage income funds where as much as 60% of portfolios have been invested in speculative derivatives. We have identified a number of funds with net assets of over $3.5 billion whose share prices are on

average down more than 20% during the first eight months of this year. In every instance the magnitude of these losses relates to the use of exotic mortgage derivatives—primarily inverse floaters, principal-only strips and inverse interest-only strips.

The purchasers of these funds were not speculators. Thousands of investors have been sold these funds based, it now appears, upon a misplaced emphasis by the sellers upon the credit quality of securities issued by the U.S. mortgage agencies while omitting disclosure of the speculative aspects of CMO derivatives. Here are some examples to illustrate the problem:

Representatives of one fund that has 25% in inverse floaters told our investigator last November that the fund was "absolutely conservative" and "very low risk." When asked what inverse floaters were, we were told they were, "sort of like a stabilizer."

In a scripted presentation from a firm's internal "roadshow," the statement that "CD investors are looking for safety and competitive yields . . . features available in [Name of Fund]."

From a story caption in a firm newsweekly, "Spotlight [Name of Fund] With Your Maturing CD Clients."

We are especially troubled by the way that these funds appear to have been targeted for sale to CD and IRA investors. We have found that federal bank regulators were quick to see the pitfalls of exotic mortgage derivatives and established policies and "stress tests" to prevent insured institutions from plunging into this market. By design, the inverse floaters and stripped securities owned by these funds fail the Federal Financial Institutions Examination Council's (FFIEC) tests and are thereby defined as "high risk."

Thus, our investigations are also examining whether fund managers have acted prudently in purchasing large amounts of these exotic securities. One such fund officer and director recently testified in a proceeding conducted by my staff that he was not aware of the FFIEC "high risk" stress tests although he saw monthly reports containing the percentage of the portfolio (invariably more than 10%) that failed the test. Other persons involved in the offer and sale of these mutual funds appear to be similarly unaware of the incompatibility of their marketing claims and portfolio purchases.

In another case my staff is investigating, well after the fund adviser was deeply committed to high risk CMOS, an expert management information systems firm found that the fund adviser lacked the critical systems necessary to support exotic mortgage-backed securities. Also absent were necessary compliance procedures. Nonetheless, the firm continued to sell shares to the public and thereby purchased another 200 million of inverse floaters with the money raised from the public.

In sum, today mutual funds are seeking to go toe-to-toe with Wall Street's dealers in derivatives. These dealers are armed with supercomputers, elaborate analytical skills and unmatched trading capabilities. We hope that mutual fund investors will not be injured when their funds enter this arena, but several have already missed the cautionary signals.

The issues I have framed require prompt attention so that all fund investors are assured that their investments are not subject to magnified or undisclosed derivatives' risks. These responses include:

Updating the Investment Company Act with the goal of protecting investors from the hazards of leveraged investments. This Committee, the SEC and many in the industry are exploring better ways to communicate fund investment risks. Such disclosure must summarize the combined effect of all of a fund's leveraging techniques, including borrowings, options and forward purchases, and instruments with embedded leverage such as inverse floaters and structured notes.

Developing a simplified means of giving investors a clear indication of the degree of a fund's risk.

Giving serious consideration to limiting the speculative use of derivatives in mutual funds offered to the general public.

Taking prompt enforcement actions against fund advisers who have misled investors about their investments in derivatives or violated fund investment limitations.

The increasing use of derivatives by mutual funds has significantly heightened the risks posed to small investors. It is essential that federal law and regulation be amended to better protect unsophisticated investors and those unable to bear the potential losses created by the use of these instruments.

Mr. MARKEY. Thank you, Mr. Koppell.

Could you just tell me how would you limit derivatives investment?

Mr. KOPPELL. Pardon me?

Mr. MARKEY. How would you limit it in mutual funds? What would be the restrictions that you would place upon it?

Mr. KOPPELL. Well, I think that just as there are limitations now on the nature of investments in money market funds, you could also place restrictions on the nature of investments in mutual funds sold to members of the general public.

As you also know, there are various types of investments that can now be sold to sophisticated investors with certain net worth characteristics that cannot be sold to the ordinary investor, and I think that you could have, and as I say, I am not prepared to affirmatively say that we should, but I think that that option should certainly be explored. Without any question, there must be better disclosure to the small investor of the risks involved in these derivative purchases by the mutual funds that they are investing in.

Mr. MARKEY. I see.

Matthew Fink is both a familiar and a welcome witness before this subcommittee. He is president of the Investment Company Institute, the trade association that represents the Nation's 5,000 investment companies. We welcome you back. Whenever you are ready, please begin.

STATEMENT OF MATTHEW FINK

Mr. FINK. Thank you, Mr. Chairman. It is good to be back. I am pleased to appear before the subcommittee to discuss investments by mutual funds in derivative instruments, and I also would like to briefly discuss the matter of personal investing by fund personnel.

The issue of mutual fund investments in derivatives has received a tremendous amount of attention recently as a consequence of some highly publicized cases where certain mutual funds suffered losses because of investments in derivatives.

But although the publicity these few instances received may give the impression that there is a widespread problem in the mutual fund industry because of fund investment in derivatives, when you put the matter in perspective, Mr. Chairman, I don't think this is the case.

First of all, relatively few funds have encountered a problem with derivatives. Most have involved money market mutual funds where the SEC has already taken steps to clarify the types of instruments that are eligible for money market funds under Rule 2a-7.

And to put the matter in perspective, even those money market funds which have encountered problems with derivatives account for only 2.5 percent of the total assets of the money market fund industry, and in only one instance, the one mentioned this morning about the community fund, in only one instance have investors lost money in a money market fund because of investment in derivatives.

With respect to non-money market funds, the type Mr. Koppell was speaking about, two points bear mention. First, to the best of our knowledge, it appears that the overall level of investment by mutual funds in derivatives is quite modest, but far more importantly is the fact that the Investment Company Act of 1940 already imposes a strict regulatory regime, the provisions of which are fully

applicable to mutual fund investments in derivatives. Therefore, it is not necessary to create a new separate regulatory regime to govern mutual fund investment derivatives. Rather, what is needed is in light of recent experience, a program, a four-part program, which we would urge, of refinements to the existing system.

The first point in our program. The recent cases involving short-term bond funds have underscored the need for clear disclosure to investors, particularly with respect to risk. Accordingly, we would endorse several steps to improve disclosure to investors.

These include: A, placing greater emphasis on disclosure regarding the volatility of a fund's portfolio as a whole, possibly including the use of existing numerical measures of risk, such as duration, and we therefore were pleased that the SEC this morning announced that it intends to invite comments in this area about use of risk measurements.

B, changes in accounting rules to require more meaningful descriptions of nontraditional investments in mutual fund financial statements.

C, expanded guidance from the NASD to brokers on the need to understand the risks of mutual funds they are offering, including risks posed by derivatives, and the need for broker-dealers to explain those risks to investors, because as Mr. Koppell just indicated, sales practices and sales literature are a critical area, but I might say, and Mr. Koppell and I are classmates, there is one point I would like to differ with him on, the ad that he passed around is not for mutual funds. It is for a closed-end fund, and when Congress drafted the Investment Company Act in 1940, it was very careful to say no leveraging in mutual funds; leveraging is permissible in closed-end funds. So I think this particular ad is somewhat off base, but it does not detract from I think Mr. Koppell's main point about the need for better sales practices, better sales literature.

And fourth, our most important recommendation in the area of improved disclosure is adoption of the SEC's proposed summary prospectus rule since we are convinced that shorter, more concise disclosure is likely to better inform investors of risk. Indeed, the use of the summary prospectus with key information, as Chairman Markey has urged, in a standardized format is probably the single most important measure that regulators could take in this area, and I firmly believe that the summary prospectus would standardize information, including standardized risk information, must be put in place as soon as possible, perhaps doing it in phases. For example, starting first with money market funds. So those are our four recommendations in the area of disclosure.

Second, we would support restoring a tougher standard on the amount of illiquid securities a mutual fund can hold. For example, by reinstating the usual 10 percent standard from the current 15 percent and therefore we were pleased to hear Chairman Levitt announce this morning that the SEC is moving in that direction.

Third, as we have testified before this subcommittee on numerous occasions, the SEC simply needs greater funding to do its job. As the securities industry continues to grow and expand the types of services and products it offers to investors, it is critical that the regulators get the resources they need to do the job.

So those are our recommendations in the area of regulation and government, but I do want to stress that our final recommendation is not a regulatory change, but it is simply important that all mutual funds that invest in derivatives ensure that their internal procedures are sufficient to reasonably ensure that their investments in derivatives are compatible with their stated objectives and in compliance with law.

I might also switch to the second subject of this hearing, personal investing by fund personnel.

As you know, in February of this year, the Institute organized a special blue ribbon committee made up of six senior industry executives to study the whole issue of personal investing by fund managers. In May, the advisory committee released its report. The report noted that mutual funds today and their personnel are subject to restrictions that go well beyond those applicable to other money managers. Despite that fact, the advisory group recommended the adoption of a series of additional stringent controls on personnel investing activities.

In June, the Institute's Board of Governors unanimously approved the report of the advisory group, and if you knew our board, that is startling that they would do anything unanimously, but the issue was that important, they did it.

But the industry has been unable to start implementing the recommendations because we have been awaiting the SEC study, which we just saw last night, and we are pleased that, for the most part, it looks like the results of the SEC survey and its recommendations track the recommendations of the advisory group. So we all seem to be in sync.

But there is one point in closing I really would like to stress, Mr. Chairman. We remain very concerned that these very stringent requirements are only going to be imposed on the personnel of mutual fund organizations. There are many other types of pool investment funds sold to the public that are totally free and exempt from these kind of restrictions.

That is going to create a tremendous competitive imbalance and I have had calls from people in the industry, Mr. Chairman, telling me they are seriously fearful of losing personnel to other managers. Now, I hope that is an issue that the SEC has in its jurisdiction and certainly the Congress itself can address.

Thank you, Mr. Chairman.

[The prepared statement of Matthew P. Fink follows:]

PREPARED STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American investment company industry.[1] I am pleased to appear before the Subcommittee today to discuss investments by mutual funds in derivative instruments. I will also briefly discuss two other matters—personal investing by mutual fund portfolio managers and other advisory personnel, and the dissemination of mutual fund prices to the press.

[1] The Investment Company Institute is the national association of the American investment company industry. Its membership includes 5,137 open-end investment companies ("mutual funds"), 461 closed-end investment companies and 13 sponsors of unit investment trusts. Its mutual fund members have assets of about $2.071 trillion, accounting for approximately 95% of total industry assets, and have over 38 million individual shareholders.

The issue of mutual fund investments in derivatives has received a great deal of attention recently. This attention is a consequence of some highly publicized cases in which certain mutual funds suffered losses on their investments in derivatives.

Although the publicity these instances received may give the impression that there is a widespread problem in the mutual fund industry because of investments in derivatives, the Institute does not believe that this is the case. Moreover, we agree with the views that SEC Chairman Levitt and Commissioner Roberts have expressed to the effect that it would be unwise to impose arbitrary limits on the ability of mutual funds to invest in derivative instruments (although, as discussed further below, certain instruments are inappropriate for money market funds). Derivative instruments, like other securities, offer both risks and rewards; there is nothing inherently problematic about them.

Our position is supported by the fact that, despite the attention that has been given to those funds that have suffered losses, it appears that these cases are, nevertheless, relatively few in number. Most have involved money market funds, where the SEC already has taken steps to clarify the types of instruments that are eligible for money market fund portfolios—steps that have been fully supported by the industry.

With respect to non-money market funds, two points bear special mention. First, and most importantly, the Investment Company Act already imposes a strict regulatory regime. The provisions of the Act are fully applicable to derivatives as all other investments. Second, it is important not to overstate the derivatives issue. To the best of our knowledge, it appears that the overall level of investment in derivatives by mutual funds is quite modest, and that most of these investments either are designed to hedge against portfolio risks or else do not involve risks substantially different than those of other investments. In fact, many funds have enhanced their performance as a result of their investments in derivatives.[2] Moreover, it appears that the market has been a highly effective regulator; among those mutual funds that invest in derivatives, many already limit or have reduced their exposure to certain types of derivative instruments.

Nevertheless, the Institute does believe that some further steps are advisable.

First, the recent cases involving short-term bond funds have underscored the need for clear disclosure to investors, especially with respect to risk. Accordingly, the Institute supports several steps to enhance the effectiveness of risk disclosure to investors. These include the following: (a) placing greater emphasis on disclosure regarding the volatility of a fund's portfolio as a whole—utilizing, where appropriate, existing numerical measures such as duration; (b) changes in accounting rules to require more meaningful descriptions of non-traditional investments in mutual fund financial statements; (c) expanded guidance from the NASD to brokers on the need to understand the potential risks of mutual funds they are offering, including risks posed by derivatives, and the need to explain these risks to investors; and (d) adoption of the SEC's proposed summary prospectus rule, since more concise disclosure is likely to better inform investors of potential risk.

Second, the Institute would support restoring a tougher standard on the liquidity of fund portfolio securities—by reinstating the 10% limit on investments in illiquid instruments by mutual funds. (This limit was raised to 15% in 1992.)

Third, as we have testified on numerous occasions, the SEC should receive greater funding. As the securities industry continues to grow and to expand the range of investment opportunities it offers, it is critical that the resources of the SEC keep pace.

Finally, although it does not require a regulatory change, the Institute believes it is important for all mutual funds that invest in derivatives to ensure that their internal controls and procedures are sufficient to reasonably ensure that these investments are consistent with their stated objectives and policies and otherwise in compliance with applicable law. In this regard, the Institute recently developed a detailed memorandum for its members on the subject of fund investments in derivatives. A copy of the Memorandum is submitted for the record.

Each of our recommendations is discussed in greater detail below. In order to provide necessary context, we first discuss the current practices of mutual funds regarding derivatives—to what extent they are used, why funds invest in them, and the extensive regulations that are applicable to such investments.

Perhaps the biggest problem in attempting to describe the extent of mutual funds, investments in derivatives is the fact that there is no agreed-upon definition of the term "derivative." Generally, a derivative has been defined as a financial instrument

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[2] *See, e.g.*, "Much Ado About...Not Much," *Newsweek* (Sept. 5, 1994) at p. 48.

whose performance or value is "derived" from that of an underlying asset, such as a security, index of securities, currency exchange rate or interest rate.[3]

Such a broad definition encompasses a vast array of securities and other instruments, including, for instance, all floating and variable rate bonds and all convertible instruments. In fact, this type of definition would probably result in every share in a mutual fund being considered a "derivative," since the performance of the fund's shares is "derived" from the performance of the securities held in the fund's portfolio.

To avoid such results, most commentators have in practice applied the term "derivative" to a specific list of instruments. Most commonly, these include options, forward contracts, futures, swaps, structured notes and, sometimes but not always, certain mortgage-backed securities.

It is important to note that many of the foregoing are not very new or exotic, but have been used by mutual funds, as well as other investors, for many years. For example, mutual funds have invested in stock options for many years. Likewise, currency forwards and futures have been used by mutual funds that invest in foreign securities in order to hedge against fluctuations in the value of the currencies in which these securities are denominated. Many mutual funds also have long invested in interest rate futures and stock index futures.

In an effort to get a more precise picture of the extent of mutual fund investments in these and other derivative instruments, the Institute conducted a survey of its members last year. The results of the survey, which are summarized below, indicate that the holdings of these types of derivatives by mutual funds are quite modest.

Our survey attempted to measure the extent of investments in various types of derivative instruments by long-term funds (i.e., funds other than money market funds), including equity, fixed income and balanced funds. In all, long-term funds representing about 75% of industry assets responded to the survey.

The survey measured the level of investments in derivatives in two different ways. The first measured the *market value* of the derivative investments. This represents the amount of a fund's net asset value represented by derivatives at the time of the survey. The survey also asked for the *notional value* of the fund's derivative investments; this represents the maximum theoretical exposure presented by the instruments. For example, the market value of an option would be its current value as of the reporting date; the notional value would be its strike price. Likewise, for futures, the market value would be the appreciation or depreciation of the position; the notional value would be the face amount of the contract. In the case of some derivatives (e.g., options and futures), the difference between the market value and the notional value could be substantial; for others (such as structured notes), there would be little, if any, difference between the two.

The findings of the Institute's survey are summarized below.

Percentage of Long-Term Fund Assets Represented by Derivatives

All Funds Responding

	Market Value (in percent)	Notional Value (in percent)
Equity	0.14	3.39
Fixed Income	1.36	7.29
Balanced	0.89	9.46
All Funds	0.78	5.67

Funds with Derivative Holdings

	Market Value (in percent)	Notional Value (in percent)
Equity	0.55	13.48
Fixed Income	3.03	16.27
Balanced	1.63	17.32
All Funds	2.13	15.51

While the data set forth, above do give some indication as to the overall level of investments in derivatives by long-term mutual funds in late 1993, it is important

[3] *See, e.g.*, Section 2 of H.R. 4745, the "Derivatives Dealers Act of 1994," introduced by Congressman Markey on July 13, 1994.

to recognize that the survey probably overstates the risk to which funds were exposed as a result of such investments. This is because the survey did not "net out" offsetting positions and includes derivative investments made for hedging purposes.[4] Even so, the positions reported are, on the whole, quite modest. It should be noted, however, that the results set forth above represent aggregate industry holdings of derivatives; individual funds may have held greater positions.

Finally, it is important to note that it appears that the recent losses suffered by several funds have led many funds to reduce their exposure to riskier derivative instruments.[5] As is often the case, the market has served as a very effective regulator.

The reason mutual funds invest in derivatives is the same as that for any other investments by a mutual fund—its investment adviser believes that they will better enable the fund to achieve its investment objectives, by providing value to the fund's shareholders in a manner consistent with the fund's investment objectives and policies.

More specifically, mutual funds generally invest in derivatives for one of two primary purposes—either as a hedge against certain risks or as an alternative to an investment in more traditional securities.

1. *Hedging*. Mutual funds often use derivatives to hedge against risks arising from other portfolio holdings. Perhaps the most common example is the use of currency forwards or futures to minimize the effect of fluctuations in currency exchange rates. Some mutual funds also hedge against interest rate risks by purchasing futures on Treasury securities.

2. *Investment Substitutes.* Mutual funds may invest in derivatives as an alternative to investing in traditional securities. In such instances, investments in derivatives may be an easier or more efficient way to achieve a desired result. At times, an investment in derivatives may be the only way for a fund to obtain a desired exposure.

For example, an index fund that seeks to replicate the performance of the S&P 500 often would find it advantageous to invest incoming cash in futures contracts on the S&P 500 on a temporary basis. This often would be cheaper than purchasing small quantities of each of the individual securities that comprise the index and still would allow the fund's additional assets to be invested consistent with the fund's investment objectives. Non-index funds also might seek to use futures at certain times for similar reasons.

Another example is a bond fund that wishes to increase its exposure to securities denominated in a certain foreign currency. The fund's adviser may find that a structured note linked to that currency and issued by a U.S. corporation provides better credit quality than a note issued by a foreign issuer. Similarly, a fund manager that believes interest rates are likely to decline ordinarily would seek to lengthen the average duration of his or her portfolio. One way to do this would be to purchase instruments with longer stated maturities. Another way would be to purchase derivative instruments, such as inverse floaters, that have the same effect.

Sometimes the suggestion is made that all investments in derivatives that are not made for hedging purposes represent "speculation," the implication being that they are somehow unusually risky or inappropriate. As the examples noted above demonstrate, however, investments in derivatives are not inherently more risky or less appropriate than other investments a fund can make.[6] In considering the propriety

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[4] Although we did not attempt to identify those investments in derivatives used for hedging purposes, it appears that a significant portion of fund investments in derivatives is directed towards hedging. For instance, our survey indicated that among the largest derivative investments by equity funds were currency forwards and futures, which, most likely, were used by international funds to offset risks from currency fluctuations.

[5] *See, e.g.* "Funds Clamping Down on Derivative Use," by Bloomberg-Business News, *Investors' Business Daily* (Aug. 30, 1994) at p. B3.

[6] A related issue that has been raised is whether competitive pressures in the mutual fund industry have led some funds to make investments in derivatives that are riskier than appropriate for those funds. The Institute does not believe these concerns are well-founded. First, the highly competitive nature of the mutual fund industry is a positive feature, which has led to over 5000 funds offering a range of investment options, shareholder services and cost structures. Second, this competition takes place in a strictly regulated environment. Finally, there is little evidence to support this contention. The competitive environment in which mutual funds operate makes fund managers keenly desirous of avoiding unexpected losses. Those bond funds that experienced large losses in recent months have seen a significant reduction in their assets due to shareholder redemptions. This, in turn, has led many other funds to reduce their investments in riskier derivatives. Moreover, as noted above, in general the level of investments in derivatives by mutual funds is modest. In fact, certain funds are emphasizing their lack of such investments in marketing materials. *See* "To Lure Investors, Funds Launch Attack on 'D' Word," *Wall Street Journal* (Sept. 20, 1994) at C1.

of any investment—derivative or otherwise—the issue should be whether it is consistent with the fund's objectives and policies as set forth in the fund's prospectus.

As we have testified before this Subcommittee on several occasions, mutual funds are subject to extensive regulation under the federal securities laws. In addition to the disclosure requirements applicable to all public issuers of securities under the Securities Act of 1933, mutual funds and other registered investment companies are subject to the provisions of the Investment Company Act of 1940, which imposes detailed, substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds.[7]

The Institute believes that the current regulatory structure is fully capable of addressing all issues that are occasioned by investments in derivative instruments by mutual funds. Set forth below is a summary of some of the key elements of this regulatory structure, with respect to both money market mutual funds and other mutual funds.

(a) *Rule 2a-7.* Money market funds (taxable and tax-exempt) raise unique issues. Unlike all other mutual funds, every money market fund has a stated investment objective of maintaining a stable net asset value (typically, $1 per share). In order to facilitate the ability of these funds to satisfy this objective, the SEC imposes detailed restrictions on the portfolio investments of money market funds. These restrictions are set forth in Investment Company Act Rule 2a-7 and are intended to minimize both the credit risk and the market (or interest rate) risk to which the funds are subject.[8]

The restrictions on money market fund portfolios were tightened in 1991. This move was strongly supported by the mutual fund industry. Shortly after these more stringent limits were imposed, the Institute urged, in a written submission to the SEC, that similar limits be imposed on tax-exempt money market funds (which had been excluded from certain of the 1991 amendments). Late last year, the SEC proposed to adopt tighter limits on the portfolios of tax-exempt money market funds. The Institute strongly supports this proposal.

The recent losses in money market fund portfolios appear to have been due to investments whose status under Rule 2a-7 was somewhat ambiguous—specifically, certain variable rate securities whose values could not necessarily be expected to reset at par (and, thus, were subject to more than minimal market risk). The SEC had sought to clarify that these securities were not eligible under Rule 2a-7 in its proposed rule amendment last year. This action was followed by an SEC staff letter this past June that specifically identified various types of variable rate instruments as inappropriate for money market funds.[9]

Several money market funds had previously purchased these instruments and consequently suffered losses. Nevertheless, it is important to note that it appears that the vast majority of money market funds did not hold any of these types of instruments. Moreover, given the strong action taken by the Commission, which the Institute strongly supports, we believe that any existing ambiguities now have been clarified.

While these developments have been characterized by many as being evidence of problems concerning derivatives, we think such an explanation is, at best, an oversimplification. The restrictions of Rule 2a-7 apply to all securities held by money market funds. Consequently, money market funds are limited to investing only in safe, liquid instruments, whether or not they are derivatives. Securities that do not meet this test are not permitted to be held by money market funds, again, whether or not they are derivatives.

Indeed, it is not even clear that the instruments on which money market funds experienced losses earlier this year would be characterized by most experts as derivatives. As noted above, these were variable rate notes whole values did not necessarily reset at par. If such notes were considered to be derivatives, then many instruments perfectly appropriate for money market funds also apparently would fall into this category, such as variable rate notes that track indexes such as LIBOR or the Federal funds rate.

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[7] In addition, mutual fund distributors are regulated as broker-dealers under the Securities Exchange Act of 1934. Mutual fund advisers must register with the SEC under the Investment Advisers Act of 1940.

[8] Money market funds that satisfy these conditions are allowed to use special methods for valuing their shares. Under the *amortized cost method*, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. Under the *penny rounding method*, share price is determined by rounding the per share net asset value to the nearest cent on a share value of a dollar.

[9] Letter to Paul Schott Stevens, General Counsel, Investment Company Institute, from Barry P. Barbash, Director, Division of Investment Management, U.S. Securities and Exchange Commission (June 30, 1994).

(b) *Disclosure Requirements.* It also is important to remember, despite the portfolio restrictions of Rule 2a-7, that money market funds are NOT guaranteed and that they can decline in value. Accordingly, the amendments adopted by the SEC in 1991 not only tightened restrictions on portfolios, they also imposed new requirements for prominent disclosure to this effect for both cover pages of prospectuses and advertisements. The cover page of the prospectus of any money market fund must state that (A) an investment in the fund is neither insured nor guaranteed by the U.S. Government and (B) there can be no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share (or, if other than $1.00, the applicable net asset value).[10] This is an important message for investors to understand: advisers to money market funds are under no legal obligation to make whole their funds for losses they have suffered.[11]

In conclusion, the industry strongly supports stringent limits on the portfolios of money market funds, as well as clear and prominent disclosure of their uninsured nature. We are hopeful that the recent steps taken by the SEC will enhance the extensive requirements that already were in place.

Among the most important provisions of the securities laws that are relevant to investments in derivatives by mutual funds are (a) disclosure requirements, (b) limits on investments in illiquid instruments, (c) daily valuation and (d) strict limits on leveraging. Each of these is discussed below.

(a) *Disclosure.* Perhaps the most important investor protections are the disclosures required of mutual funds. As SEC Chairman Levitt recently stated, "What's important is that the risk of derivatives in . . . funds be disclosed to investors, and then they can decide if they want to take the greater-than-market risk to get greater-than-market returns." [12]

Among the current disclosure requirements relevant to investments in derivatives are the following:

Prospectus Disclosure—A mutual fund that invests, or that may invest, in derivative instruments must include disclosure concerning those investments in its prospectus, just as it must for other securities. In February 1994, the SEC's Division of Investment management issued guidance to funds on derivatives disclosure, noting that current disclosure often was "lengthy and highly technical in nature" and accordingly encouraging funds to revise their disclosure in a manner that would "enhance investor understanding about pertinent risks." [13]

The staff of the SEC also has reportedly been requesting various specific disclosures in fund prospectuses in recent months. These include disclosure regarding the risks of investing in certain types of derivative instruments, disclosure that using derivatives to enhance income is speculative, disclosure of the purpose of using certain derivative instruments and an explanation of how a fund's use of derivatives can be reconciled with relatively conservative investment policies suggested by the fund's name.[14]

Any material misstatements or omissions in the disclosure included in a fund's prospectus are subject to strict liability under the Securities Act of 1933. This stringent standard imposes a significant degree of discipline upon the industry in ensuring that a fund's investment program does not digress from the disclosure included in its prospectus.

Reports to Shareholders—In 1993, the SEC adopted a new requirement that mutual funds provide to shareholders a periodic discussion of performance. Most funds include such a discussion in their annual reports. (Some include it in their prospectuses.) The discussion must include all investment strategies and techniques that materially affected the performance of the fund during the past year. To the extent that these strategies or techniques involved derivatives, investors will be informed not only in which types of derivative instruments a particular fund can invest, but also how the fund actually used derivatives during the past year and what effects- positive or negative—they had on the fund's performance.

Financial Statement Disclosure—All instruments held by a mutual fund are required to be identified in the fund's schedule of investments, which is part of its annual and semiannual reports. Applicable laws and accounting principles require

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[10] Item 1(a)(vi) of Form N-1A.

[11] The Institute has undertaken a major public information initiative this year, including a video news release, emphasizing the uninsured nature of money market funds and other mutual funds.

[12] "SEC Chief Calls For More Cops And Disclosure," *Money* (Sept. 1994) at p. 75.

[13] *See* Letter to Investment Company Registrants (SEC Division of Investment Management No-Action Letter), pub. avail. Feb. 25, 1994.

[14] *See* Remarks of Richard Y. Roberts, Commissioner, U.S. Securities and Exchange Commission, "Directors Should Focus Attention on Derivatives Activities," Spotlight on Derivatives Conference, New York, NY (Sept. 13, 1994) ("Roberts Speech").

various specific disclosures concerning certain types of derivative investments (e.g., with regard to option writing). The Financial Accounting Standards Board ("FASB") has proposed a Statement of Financial Accounting Standards that would be applicable to mutual funds, as well as other issuers, and would require more detailed disclosure in financial statements concerning investments in derivatives.

(b) *Liquidity*. Another important investor protection that is relevant to investments in derivatives by mutual funds is the SEC-imposed limit on illiquid assets. Specifically, a mutual fund cannot invest more than fifteen percent of its net assets in illiquid assets, which are defined by the SEC staff as assets that may not be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the asset.[15] This limitation applies equally to derivative and non-derivative securities.

It is important to note that many types of derivative instruments in which mutual funds invest are liquid. These would include exchange-traded derivatives, such as certain options, futures and options on futures. In addition, many derivatives traded in the over-the-counter market, such as currency forward contracts, also have deep and liquid markets. With respect to other derivative instruments, they generally must be reviewed on a case-by-case basis; among the relevant factors are any restrictions on transferability, the availability of market bids from multiple sources, the feasibility of entering into offsetting transactions, and any rights of the fund to close out the position on a marked-to-market basis.

(c) *Pricing*. One of the most important disciplines imposed upon mutual funds is the requirement that they mark their entire portfolios to market every day. In this regard, derivative instruments are treated no differently than any other instruments held by a mutual fund.

Mutual funds that hold certain types of derivative instruments, especially certain over-the-counter derivatives, generally employ specific procedures for verifying the prices of these instruments. These procedures include verifying prices with quotes from third parties, replicating the pricing of more complex securities by analyzing separately their component parts, and periodically comparing the proceeds received from the sale of an instrument to its previous valuation.

(d) *Leverage*. The Investment Company Act generally prohibits mutual funds from issuing "senior securities," which has been interpreted by the SEC to limit a fund's ability to employ leverage. Essentially, if a fund makes an investment that may result in it owing more money than the amount of such investment (e.g., by writing an option), the fund is required either to hold an offsetting position (e.g., by owning the underlying security) or to set aside in a segregated account liquid, high-grade debt securities, in an amount sufficient to cover its potential future obligation.

These requirements apply to all derivative investments by mutual funds and thus serve to limit the extent to which a fund can be leveraged. It is thus not true that, as has been reported occasionally, derivative investments allow mutual funds to evade the 1940 Act's leverage provisions.[16]

In general, the Institute does not believe that there is a need for significant regulatory action concerning mutual fund investments in derivatives. As noted above, most of the recent events that have elicited concern involved money market funds, and the SEC already has clarified that the more volatile instruments are ineligible under Rule 2a-7.

The investor protection provisions of the securities laws cannot ensure against losses due to price declines in the market, nor should they be expected to. Like all securities, derivative instruments offer both rewards and risks. The Institute does not believe it would be in the best interests of mutual fund investors to restrict their ability to participate in this market.[17] Indeed, mutual funds are an especially appropriate vehicle through which the public can invest in derivatives, since funds offer

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[15] Money market mutual funds, investments in illiquid assets are limited to ten percent of net assets.

[16] Certain derivatives, notably some types of structured notes, are occasionally referred to as "leveraged" because their coupon varies to a greater degree than the value of the underlying asset or index. An example would be a note whose coupon changes twice as much as changes in LIBOR. Such notes, however, do not raise the leverage concerns addressed by the Investment Company Act, since the fund's potential exposure is limited to the value of its initial investment.

[17] As SEC Commissioner Roberts recently stated, "[O]ther than with respect to money market mutual funds, specific investment restrictions do not make much sense to me in the mutual fund area. I am inclined to believe that, as a general proposition, the marketplace and not the Commission should determine the success or failure of the various potential investment products available to the mutual fund industry, even if they are highly volatile." Roberts Speech at p. 5. SEC Chairman Levitt has expressed similar views. "SEC Chief Calls For more Cops And Disclosure," *Money* (Sept. 1994) at p. 75.

the benefits of diversification, professional management and, perhaps most importantly, strict regulation.

The Institute does believe, however, that certain steps on the part of the regulators and the industry would enhance investor protection.

1. *Improved Disclosure*. While, as both Chairman Levitt and Commissioner Roberts have noted, there is nothing improper about mutual funds seeking increased returns while subjecting themselves to additional risk, it is crucial that such risks not be inconsistent with the expectations of their shareholders. This, in turn, requires that disclosure about the fund's investment policies, and in particular their associated risks, be set forth in a clear and concise manner.

The Institute has four specific recommendations to improve the quality of disclosure.

First, the SEC should place greater emphasis upon risk disclosure that addresses a fund's portfolio as a whole in mutual fund prospectuses. We believe this would provide more useful information to investors than the voluminous and detailed disclosures about the characteristics of individual instruments that is now often required. This latter sort of disclosure can actually be misleading; for instance, a specific instrument could be relatively volatile in and of itself, yet if it is designed to offset the volatility of another instrument held by the same fund, its effect could be to reduce the overall riskiness of the fund.

In this regard, mutual funds should be encouraged to use existing numerical measures of portfolio risk in appropriate circumstances. For example, duration is one measure used for interest rate exposure. Such a measure could be useful for investors in government and other high quality bond funds, where interest rate exposure is the primary risk, as a means for comparing different funds. (In order to be able to utilize duration or other measures in this way, it will likely be necessary to develop some standardized methodology for computing it.)

The Institute believes that this approach is likely to prove far more useful to investors than attempts to come up with a single all-encompassing measure of risk, an idea that has been suggested by some. Among the inherent problems in developing such a measure are (1) that it is quite likely to be wrongly taken by investors to indicate a measure of the fund's future riskiness; and (2) that investors might focus only on the numerical measure and neglect important risk information included in narrative disclosure. The search for such an all-encompassing risk measure is likely to be elusive and, in any event, is no panacea.[18]

Second, the Institute would support changes to current accounting rules that would empire more meaningful descriptions of non-traditional investments in mutual fund financial statements. As noted above, a fund's investments in derivatives already are subject to disclosure requirements applicable to financial statements. In certain cases, however, current standards may not be sufficient to ensure that the disclosure in financial statements is adequate to give investors a full understanding of the nature of certain types of derivative securities. For example, a note whose coupon rate is inversely related to the value of the Italian lira could be reported as simply a "floating rate note." The Institute believes that many, if not most, funds that hold such instruments already voluntarily go beyond the minimum disclosure required and provide sufficient information to enable the reader to understand the nature of the instruments. It would be advisable, however, for this type of more detailed disclosure to be required, so that it would be applicable in a uniform manner to all funds.

Third, in recognition of the fact that brokers, financial planners and other sellers of mutual funds are an important source of disclosure, the Institute recommends that the NASD issue a notice that would strongly emphasize to its members their obligations to understand fully the nature of the funds they are selling and to disclose relevant facts to their customers. The notice should focus specifically on bond funds that are relatively volatile (including specifically those cases where such volatility is due to investments in derivatives). The NASD has issued similar notices in the past, concerning the general risk characteristics of bond funds and funds sold through the bank channel.[19]

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[18] In this regard, it is instructive to note that one short-term bond fund that suffered relatively large losses earlier this year had held a "5-star" ranking from Morningstar, Inc. (the highest "risk adjusted" rating by such company). *See* "Derivatives Help Mutual Funds Manage Risk," *Star Tribune* (July 3, 1994) at p. 2D. Morningstar itself recognizes the limitations of its star system, noting that it is not a predictive measure, but rather a descriptive representation of *past* risk and return..

[19] *See, e.g.*, NASD Notice to Members 93-87 (December 1993); NASD Notice to Members 91-74 (November 1991).

Finally, the Institute believes that one of the most important steps the SEC could take to enhance investor understanding is adoption of the pending summary prospectus proposal. Under the SEC's proposal, a mutual fund would be able to use a summary prospectus that would be required to include all key information about the fund, but in a concise format. The summary prospectus would be subject to full prospectus liability and investors would be afforded the opportunity to obtain the full prospectus for more complete information before making an investment decision.[20] The Institute believes that the summary prospectus would be especially well-suited to providing clear, concise and readily accessible risk information about mutual funds—including, for example, disclosure relating to overall portfolio risk—that investors could more readily understand than lengthier, more detailed disclosure.

2. *Tighter Liquidity Standard*. One concern that has been expressed about mutual fund investments in derivative securities is that some of these securities may be relatively illiquid. As noted above, the restrictions on investments in illiquid securities by mutual funds apply with full force to investments in derivatives, and many derivatives in which funds invest are highly liquid. Nevertheless, in order to provide for additional protection, the Institute would support a return to the 10% limit on investments in illiquid securities that was in place before the SEC raised the limit to 15% in 1992.

3. *Greater SEC Resources*. Another concern that has been expressed is that the SEC may have been unaware of the extent of mutual fund investments in derivatives. While we do not agree with that assessment and while it is important to remember that the primary responsibility for compliance properly rests with individual funds and their investment advisers, the industry's continued success also depends on an effective regulatory agency. For this reason, as we have testified previously on numerous occasions, it is imperative that Congress ensure that the SEC receives funding at a level that is sufficient to enable it to carry out its investor protection mission.

4. *Industry Compliance*. The Institute's fourth and final recommendation does not involve a regulatory change. Nevertheless, it may be the most important. It is the need for all mutual funds that invest in derivatives to ensure that their internal procedures and controls are adequate to accommodate such investments. Specifically, funds that invest in these securities must have systems and procedures in place to reasonably assure that these investments will be consistent with the fund's investment objectives and policies, as set forth in its prospectus, and otherwise in compliance with applicable law. Even though derivatives do not raise fundamentally different issues than other securities, the Institute recognizes that some types of derivatives are novel and/or complex and thus may necessitate modification of compliance procedures that were designed for more traditional securities.

In an effort to aid the industry in this matter, the Institute recently prepared a detailed memorandum on investments in derivatives by mutual funds. The memorandum, which is addressed to fund boards of directors and to senior management of investment advisers to funds, is designed to highlight relevant issues and to suggest possible areas for inquiry and consideration by fund boards and investment advisers. The memorandum has been very well received, not only by our members, but by others as well. Commissioner Roberts stated that he thought the memorandum "was outstanding" and "should be required reading for investment advisers and directors, among others."[21]

Among the points stressed in our memorandum is the need for mutual funds that invest in derivatives to satisfy themselves that their investment programs are consistent with the reasonable expectations of investors. In making such determinations, funds should consider their prospectus disclosure and such other factors as the name of the fund and disclosure included in advertising and sales material.[22] Funds also need to consider whether existing procedures for analyzing the credit and market risks of fund investments may need to be revised or refined to cover appropriately derivative instruments. This analysis should enable funds to evaluate the impact of investments in derivatives on the volatility of the fund's portfolio as a whole in order to determine whether these investments are compatible with the fund's stated objectives and policies.

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[20] In any case, the full prospectus would have to be sent no later than with the confirmation of any purchase order.

[21] Roberts Speech at 9.

[22] In this regard, it is important to note that the mutual fund industry has been very active in promoting greater understanding of derivatives and how they are used by funds. Many fund complexes have prepared special brochures about derivatives that offer their investors straightforward explanations about this subject. Others have included expanded discussions on this topic in their periodic reports to shareholders.

Among other procedures that funds that invest in derivatives may have to review and that are discussed in our memorandum are ones to evaluate the liquidity of and to properly value any derivative instrument, such as those mentioned above.

The importance of compliance procedures goes beyond investments in derivatives, of course, and is an issue that has been stressed by SEC Chairman Levitt. In testimony before this Subcommittee last year, Chairman Levitt noted that, "[F]unds must be diligent in examining their internal procedures on an ongoing basis to ensure the highest level of compliance."[23]

Earlier this year, press reports indicated that a prominent mutual fund portfolio manager had been relieved of his duties because he allegedly failed to comply with his firm's internal procedures relating to securities trading practices. This, along with other reports on personal investing by portfolio managers led to a high degree of interest in the subject on the part of the press, Congress and the SEC.

In order to evaluate current law, regulation and industry practices and to consider the need to revise existing standards, the Institute announced the formation of a special industry Advisory Group in February of 1994. The Advisory Group, which comprised six senior mutual fund executives, held a series of meetings in which it sought the views of numerous experts. The Advisory Group also conducted a detailed survey of the compliance practices regarding personal investment followed by 96 investment company complexes.

The Advisory Group's report was released on May 9, 1994. (A copy is attached for the record.) The report noted that investment companies, alone among asset managers, are subject to specific statutory and regulatory provisions (e.g., Section 17(j) of the Investment Company Act and Rule 17j-1 thereunder) that require, among other things, the adoption of a Code of Ethics designed to prevent fraudulent, manipulative or deceptive conduct in connection with personal trading of securities held or to be acquired by an investment company; quarterly reporting on personal securities transactions; and detailed recordkeeping requirements. The report also noted that compliance with these requirements is addressed through the SEC's inspection and enforcement programs.

In addition, the report reviewed actual compliance programs adopted by the industry. It found that most Codes of Ethics far exceeded the minimum legal requirements established under SEC rules.

Despite the unique and rigorous standards governing personal investing prevalent in the industry, the Advisory Group felt that it was advisable for the industry to adopt a series of *additional measures* designed to obviate conflicts, prevent and detect abusive practices, and preserve the confidence of investors. These recommendations included:

A prohibition on investment personnel (e.g., portfolio managers, analysts and traders) participating in initial public offerings.

Heightened scrutiny, including express prior approval, of any acquisition of securities by investment personnel in a private placement.

Blackout periods during which access persons[24] would be precluded from executing securities transactions involving securities traded by a fund or on which any fund in the complex has a pending buy or sell order.

A requirement that any profits realized by investment personnel on purchases and sales occurring within a 60 day period be disgorged.

A prohibition on the receipt of gifts of more than *de minimis* value from any person that does business with the fund.

Strict limits on investment personnel serving as directors of publicly traded companies.

Mandatory preclearance of all personal securities trades.

A requirement that all access persons direct their brokers to supply copies of confirmation statements and periodic statements to compliance officers of the fund.

A recommendation that the NASD adopt a rule requiring all broker-dealers to notify a registered investment adviser whenever an employee of the adviser opens a brokerage account.

Implementation of procedures to monitor personal investment activity after preclearance has been granted.

Disclosure of all securities holdings by investment personnel upon the commencement of employment and thereafter on an annual basis.

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[23] Statement of Arthur Levitt, Before the Subcommittee on Telecommunications and Finance, U.S. House of Representatives, August 4, 1993 at 13.

[24] "Access person" is defined in Investment Company Act Rule17j-1. It covers a broad range of persons, as the Rule is intended to apply to all persons "who have an active part in the management, portfolio selection or underwriting functions" of an investment company. *See* Investment Company Act Rel. No. 11421, 21 SEC Dkt. (CCH) 488, 493 (Oct. 31, 1980).

Certification by all access persons that they are in compliance with their fund's Code of Ethics on an annual basis.

Annual reports to fund directors.

Disclosure in fund prospectuses or Statements of Additional Information regarding the fund's policies with respect to personal securities investing.[25]

The Advisory Group's recommendations were unanimously approved by the Institute's Board of Governors at a special meeting held on June 30, 1994. The Institute's Board strongly recommended that all investment companies and their investment advisers incorporate the recommendations included in the report into their own Codes of Ethics no later than January 1, 1995. We anticipate that once the SEC releases the results of its survey of personal investing practices, Institute members can be expected to incorporate the Advisory Group's recommendations in an Appropriate and timely fashion.

The Institute believes that the actions of the Advisory Group and our Board of Governors underscore the strong commitment on the part of the industry to the highest standards of integrity. We were also pleased that SEC Chairman Levitt, in a letter sent to the Institute after the Board approved the report's recommendations, stated that he believed that the recommendations did constructively address the conflicts of interest that arise when portfolio managers engage in personal trading.

Another issue that received some attention concerned the dissemination of fund prices to the press. Concerns arose after it was reported that a major fund complex had incorrectly reported the previous day's prices to the NASD, which forwarded this incorrect information to various news services.

It is important to keep the matter in context. We understand that, despite the fact that incorrect prices appeared in the nation's newspapers, all actual purchases and redemptions were executed at the correct prices.

This incident, however, served to underscore the serious pressures imposed on fund complexes in disseminating their pricing data to the news media. While the public generally had been unaware of this issue, it is one that the Institute has been working on since last year. Until very recently, the NASD imposed a deadline of 5:30 p.m. for delivery of prices. This deadline exists due to the demands of the newspaper wire services, which, in turn, are responding to the needs of newspapers across the country to complete their production cycles on a timely basis.

Given the extensive computational and quality control procedures that funds undertake in pricing their portfolios, it is very difficult for funds to meet this deadline.[26] The problem is exacerbated by the fact that prices must be manually entered into an NASD terminal. Inevitably, there are mistakes or missed deadlines. We un-

[25] The Advisory Group considered, but rejected, the idea of a ban on personal investing by portfolio managers. There were several reasons for this. To quote from the Report: "First, investment management firms compete fiercely in the market place, above all on the basis of their performance for investors. No investment company will succeed unless its first priority is the interest of its shareholders. In this competitive environment, the Advisory Group believes that investment companies will not tolerate personal investing activity of a nature or level that disserves the interest of shareholders.

Second, the Advisory Group believes that the potential conflicts arising from personal investing activities can be addressed decisively—and the public's trust fully vindicated—through effective restrictions and procedures that do not constitute a total ban. The former Commission members and senior officials with whom the Advisory Group met in the course of its work concurred unanimously in this judgement.

Third, the Advisory Group is convinced that a total ban on personal investing would arbitrarily and unfairly foreclose, potentially to many thousands of individual employees, wholly legitimate and appropriate investment opportunities. Based on the Advisory Group's review, such a ban would be unprecedented and would far exceed accepted notions of fiduciary conduct or any reasonable expectations of ethical accountability.

Finally, as senior executives in the industry, the Advisory Group notes the widespread expressions of concern—which are legitimate—that foreclosing portfolio managers from opportunities to invest directly in the markets not only would detract from the very portfolio management abilities on which shareholders rely, but would establish significant and needless disincentives to the continued service of these talented individuals in the industry. This is especially true in the absence of comparable restrictions on other types of asset managers. In the end, the Advisory Group believes that a ban would operate to the detriment of millions of individual fund shareholders and of the industry at large."

[26] Briefly, the pricing process involves obtaining prices for all portfolio securities from pricing services and market makers, a process which generally begins at the close of the markets for those securities. In the case of securities listed on the New York Stock Exchange, the closing time is 4:00 p.m., Eastern time. (Funds may use more than one pricing service or may use secondary pricing sources as an additional control measure.) The fund's net asset value is then computed by adding the value of its portfolio holdings to its other assets, subtracting liabilities, and dividing by the number of the fund's shares that are outstanding.

derstand that these are relatively infrequent,[27] however, and, in any event, and importantly, the incorrect reporting of prices in the news media, as noted above, does not affect the accuracy of those prices at which purchases and redemptions are effected. This is because most incorrect prices are corrected prior to the commencement of a fund's nightly processing cycle, but beyond the time which such prices can be reported to the news media. (Any material errors discovered after this time are corrected as soon as they are discovered.)

The Institute, on behalf of the mutual fund industry, has been engaged in ongoing discussions with the NASD, the news wire services and other interested parties to consider technical and operational enhancements designed to improve the price reporting process. An important first step was announced on July 11, when the NASD pushed back the deadline for receipt of price data from funds to 5:40 p.m. The NASD also announced improved procedures for alerting it and the wire services about delays in meeting the deadline.

The industry is continuing to press for further enhancements. We recently submitted a set of proposals that would include development of a "rolling receipt and dissemination" system, which would allow funds to send prices to the NASD on a fund-by-fund basis without necessitating manual transmission. In addition, the NASD would serve more of a conduit role, thus eliminating the need for it to retransmit information to the wire services, which would give funds more time to calculate and verify their daily prices. Our objective is to achieve an agreement among the industry, the NASD and the media on a long-term solution by the end of this year and to provide ongoing assistance to the NASD to assure its effective and timely implementation.

In conclusion, while misreporting of prices to the news media is an event that is both rare and one that does not result in out-of-pocket losses to investors, the mutual fund industry nevertheless believes that whatever steps that are feasible to further improve the price reporting process should be taken. We will continue to work towards this end.

Each of the matters discussed in my testimony—mutual fund investments in derivatives, personal securities investing by fund portfolio managers and other employees, and reporting of fund prices to the news media—are ones that the mutual fund industry takes very seriously. As I believe my testimony indicates, in each case the industry has taken the initiative to seek improvements that will benefit our shareholders. We will continue to do so in all three areas, as well as with respect to any other issues that may arise.

Mr. MARKEY. Thank you, Mr. Fink, very much.

And our final witness is Don Phillips, who is the publisher of Morningstar, which is one of the country's leading research services analyzing the mutual fund industry. He and his colleagues have provided valuable insights to this subcommittee as we have increased our focus on activities in the fund industry during the past several years. We are pleased to welcome you before the subcommittee, Mr. Phillips. Whenever you feel comfortable, please begin.

STATEMENT OF DON PHILLIPS

Mr. PHILLIPS. Thank you very much Chairman Markey and other members of the subcommittee. Thank you for the opportunity to address your hearings. I have been invited here by the subcommittee staff as an objective observer of the fund industry, someone who is in direct daily contact with investors, financial planners, fund management companies, and the press.

If I have a bias, it is that I care passionately about the long-term health of the industry, both as a publisher of data on it and as an active investor in its products. Given that concern, I would like to congratulate this subcommittee for its continued efforts towards

[27] We have been informed that the NASD, on average, receives subsequent corrections for fewer than 20 of the approximately 4500 prices supplied to the news media each day (i.e., less than one-half of one percent).

keeping mutual funds operating on the cleanest, best-lit playing field in all of finance.

As you know, the fund industry has come under increased scrutiny in recent months. The public and press are understandably concerned about an industry that so many Americans have entrusted to help fund their children's educations and their own retirements.

Of late, the natural periodic discomfort of lower-market returns has been aggravated by allegations of misleading advertising, trading conflicts of portfolio managers, and the improper use of exotic mortgage derivatives in portfolios sold to the public as low-risk investments.

While these issues are discomforting, the mark of an industry's health is not the amount of criticism it receives, but the manner in which it responds to that criticism. I think that the fund industry's response to the issues of misleading advertising and of improper trading by portfolio managers has been swift, responsible, and appropriate, and I would like to congratulate the industry and its regulators for their prompt and proper response to these important issues.

What I would like to address today is the issue of less liquid securities, such as exotic mortgage derivatives, and the threat they pose to the industry and the investing public. Open-end mutual funds offer many advantages, but efficient participation in illiquid securities is not one of them.

At the heart of the public's trust in mutual funds is the notion that a dollar is a dollar, that a fund's share costing, for example, $15, represents ownership of securities that could readily be sold for $15 in cash. This basic trust forms the bedrock on which the entire fund industry stands.

Unfortunately, with the rapid growth of funds and the increased use of less liquid securities, including exotic mortgage derivatives, but also emerging market securities, private placements, and other more speculative fare, this most basic of assumptions is now being called into question.

At the same time that fund marketers are cashing in on the industry's well-deserved reputation for dependability, its portfolio managers are aggressively buying newer and less liquid securities in order to boost performance and differentiate their funds from an increasingly competitive field. Investments that didn't even exist a few years ago, or ones that historically have been the domain of hedge funds or venture capital pools are finding their way into the portfolios of mainstream America through mutual funds.

While I think it is exciting that public pools of monies are now pursuing investments once reserved only for lead institutions, I also think that it is imperative that investors be able to distinguish those funds that are mining these new territories from those that are staying with the more traditional realm of readily-traded securities.

A double-digit loss in an investment clearly marked as a higher-risk choice should not derail an individual's investment program. What is debilitating, however, is a significant loss in a fund positioned as a conservative low-risk choice, something we have seen too frequently this year.

I have been asked to share with this committee my thoughts on what role Congress and the SEC might take to protect investors. Let me note that I think the role of regulation should not be to prevent investors from taking risks, but to ensure that investors can reasonably assess the risks that they are taking.

Such was not the case in the recent experience of funds holding mortgage derivatives. Here, even the most diligent of investors could not have properly assessed which funds were taking which risks. The true nature of many of these securities was often disclosed only in a footnote or was obscured entirely in the published listings of fund portfolio holdings.

For example, one U.S. Government bond fund that is down sharply this year, due to a significant holding in what is called an inverse floater, failed to note in its published holdings list the true nature of the security. The footnote declared that the security was a floating rate note, but not that it was an inverse floater.

As floating rate notes are among the most conservative of investments and inverse floating rate notes among the most highly leveraged and aggressive, this vague labeling could hardly have been less useful. Even the most sophisticated shareholder could not have adequately assessed the true risk of that fund.

The problem is compounded by the infrequent and nonuniform release of portfolio holdings. As it now stands, funds are required to release their portfolios only twice a year and not on uniform dates, such as the end of a calendar quarter, thus, making timely, direct comparisons among funds difficult, if not impossible.

I propose that the industry standardize the disclosure of derivative securities and not relegate key information to the financial footnotes. I also suggest that fund companies make their portfolios available on a monthly basis to the press, third-party research organizations, and other interested groups so that independent sources can apply uniform analysis to all funds to see if identical securities are priced similarly across portfolios and organizations.

I am not suggesting, however, that funds be required to send every shareholder this information. Too much data can be as detrimental to the investor as to little. This action would create a better paper trail of which funds are taking which risk and would allow a vigorous public discussion of which funds are therefore appropriate for which investors. It would also decrease the chances that a fund manager would inflate his or her fund's NAV (Net Asset Value) by supplying unrealistic prices for securities that are not frequently traded.

In addition, I think the pressures that tempt fund managers to take greater risks should be addressed. Much of this pressure, of course, owes simply to competition. With more funds and increased media coverage, fund managers are under tremendous pressure to perform. To a degree, that is healthy.

What is problematic is the unevenness of the playing field on which these managers compete. If managers are judged on a level playing field, it is relatively easy for spectators to assess performance accurately. Unfortunately, due to the increased use of 12b-1 fees, fees that tack marketing expenses onto a fund's operating expense ratio, many fund managers are placed at a material disadvantage to their peers.

It is relatively simple to leave front-end or deferred sales charges, two alternative means of recouping marketing fees, out of a comparison between managers. It is far more difficult, and not the media's current policy, to extract fees that have been appended to the expense ratio in making such evaluations.

For example, the grades that appear daily in The Wall Street Journal include the effects of 12b-1s, but do not include the effect of front-end or deferred sales charges. As a portfolio manager would prefer to get an A grade in The Wall Street Journal to a B, C, D, or E grade, there is pressure to increase performance through added risk taking.

These management and operating fees are generally similar among funds with like objectives. The primary difference between high and low expenses is the level of 12b-1 fees. Curtailing the use of these fees would provide a more level playing field and strengthen the industry's health by separating management and marketing concerns.

Currently, a manager assigned a fund with a high 12b-1 fee must take considerably more risk than he or she would take with a lower cost fund just to try to produce the same yield for his shareholder. It is one thing for a manager to accept added risks for investment reason. It is something altogether different for a manager to take more risk to overcome a marketing cost.

Too frequently these added risks have gone awry and have come back to hurt investors. The SEC can't and shouldn't regulate away risk-taking, but it can seek to ensure that the risks taken in their portfolio are taken for investment reasons, not to compensate for marketing costs that have been inserted into the investment equation.

These suggestions won't guarantee that no investor will take inappropriate risks in the future, but they will help ensure that the playing field on which funds operate remains well lit and free of unnecessary obstacles. I would like to thank the committee for the opportunity to participate in this public discussion on mutual funds. I eagerly await the opportunity to answer any questions you may have of me.

Thank you.

[The prepared statement of Donald J. Phillips follows:]

Testimony of Donald J. Phillips II

Publisher, *Morningstar Mutual Funds*

On Issues Concerning the Mutual Fund Industry

Chairman Markey, Representative Fields, and other members of the subcommittee:

Thank you for the opportunity to address your hearings. I'm Don Phillips, the publisher of *Morningstar Mutual Funds*, an independent research publication dedicated to helping individuals make better investment decisions. For background, it may be helpful for you to know that Morningstar does not accept advertising, manage money, or provide consulting services to the fund industry. We have tried to align our interests as closely as possible with those of individual fund investors.

I've been invited here by the subcommittee staff as an objective observer of the fund industry, someone who is in direct, daily contact with investors, financial planners, fund management companies, and the press. If I have a bias, it's that I care passionately about the long-term health of the industry, both as a publisher of data on it, and as an active investor in its products. Given that concern, I'd like to congratulate this subcommittee for its continued efforts toward keeping mutual funds operating on the cleanest, best-lit playing field in all of finance.

Increasing Criticism

As you know, the fund industry has come under increased scrutiny in recent months. The public and press are understandably concerned about an industry that so many Americans have entrusted to help fund their childrens' educations and their own retirements. Of late, the natural, periodic discomfort of lower market returns has been aggravated by allegations of misleading advertising, trading conflicts of portfolio managers, and the improper use of exotic mortgage derivatives in portfolios sold to the public as low-risk investments.

While these issues are discomforting, the mark of an industry's health is not the amount of criticism it receives, but the manner in which it responds to that criticism. I think that the fund industry's response to the issues of misleading advertising and of improper trading by

portfolio managers has been swift, responsible, and appropriate. While I am dismayed that the NASD took nearly a year and a half to speak publicly about deceptive advertisements run by the Pilgrim Group--ads that Chairman Markey, in the November 8, 1993 issue of Time magazine, described as "the most egregious examples of manipulating mutual-fund rankings of which I am aware"--I take comfort that the new advertising guidelines supported by the Investment Company Institute will lessen the number of misleading ads produced by fund companies in the future.

I also think that the industry's response to the issue of conflicts arising from the personal trading activities of fund managers has been appropriate. While the blue-ribbon panel assembled by Matt Fink of the ICI stopped short of banning manager trading--the only step that would fully ensure that no future abuses would occur--it did take many steps that will lessen the likelihood of future abuses. I think the panel drew the line in the right place. To prohibit entirely the personal trading activities of managers would limit the industry's ability to attract top investment professionals, and thus do a disservice to fund shareholders. So, again, my congratulations go to the industry and its regulators for their prompt and proper response to an important issue.

Illiquid Securities

What I would like to address today is the issue of less-liquid securities, such as exotic mortgage derivatives, and the threat they pose to the industry and the investing public. Open-end mutual funds offer many advantages, but efficient participation in illiquid securities is not one of them. At the heart of the public's trust in mutual funds is the notion that a buck is a buck--that a fund share costing, for example, $15.00 represents ownership of securities that could readily be sold for $15.00 in cash. This basic trust forms the bedrock on which the entire fund industry stands. Unfortunately, with the rapid growth of funds and the increased use of less-liquid securities--including exotic mortgage derivatives, but also emerging-market securities, private placements, and other more-speculative fare--this most basic of assumptions is now being called into question.

At the same time that fund marketers are cashing in on the industry's well-deserved reputation for dependability, its portfolio managers are aggressively buying newer and less-liquid securities in order to boost performance and differentiate their funds in an

increasingly competitive field. Investments that didn't exist a few years ago, or ones that historically have been the domain of hedge funds or venture-capital pools, are finding their way into the portfolios of mainstream America through mutual funds. While I think it is exciting that public pools of monies are now pursuing investments once reserved only for elite institutions, I also think that it is imperative that investors be able to distinguish those funds that are mining these new territories from those that are staying within the more traditional realm of readily traded securities. A double-digit loss in an investment clearly marked as a higher-risk choice should not derail an individual's investment program. What is debilitating, however, is a significant loss in a fund positioned as a conservative, low-risk choice--something we've seen too frequently this year.

Suggestions

I have been asked to share with this committee my thoughts on what role Congress or the SEC might take to protect investors. Let me begin by noting that I think the role of regulation should be not to prevent investors from taking risks, but to ensure that investors can reasonably assess the risks that they are taking. Such was not the case in the recent experience of funds holding mortgage derivatives. Here, even the most diligent of investors could not have properly assessed which funds were taking which risks. The true nature of many of these securities was often disclosed only in a footnote, or was obscured entirely in the published listings of fund portfolio holdings.

For example, one U.S. government bond fund that is down sharply this year due to a significant holding in what is called an "inverse floater" failed to note in its published holdings list the true nature of this security. A footnote declared that the security was a floating-rate note, but not that it was an *inverse* floater. As floating-rate notes are among the most conservative of investments and inverse floating-rate notes among the most highly leveraged and aggressive, this vague labeling could hardly have been less useful. Even the most sophisticated shareholder could not have adequately assessed the true risk of that fund. This problem is compounded by the infrequent and non-uniform release of portfolio holdings. As it now stands, funds are required to release their portfolios only twice a year and not on uniform days--such as the end of a calendar quarter--thus making timely, direct comparisons among funds difficult, if not impossible.

I propose that the industry standardize the disclosure of derivative investments and not

relegate key information to the financial footnotes. I also suggest that fund companies make their portfolios available on a monthly basis to the press, third-party research organizations, and other interested groups so that independent sources can apply uniform analysis to all funds to see if identical securities are priced similarly across portfolios and organizations. (I am not suggesting, however, that funds be required to send every shareholder this information--too much data can be as detrimental to an investor as too little.) This action would create a better paper trail of which funds are taking which risks, and would allow a vigorous public discussion of which funds are therefore appropriate for which investors. It would also decrease the chances that a fund manager would inflate his or her fund's NAV by supplying unrealistic prices for securities that are not frequently traded.

I would also suggest that the SEC reconsider its recent move that raised to 15% from 10% the percentage of illiquid securities that an open-end mutual fund may hold. Such a retrenchment would be somewhat symbolic: the current definition of illiquid securities does not include many securities, such as exotic mortgage derivatives, that in practice have proved to be illiquid when held in the quantities typical of mutual funds. Moreover, Wall Street's ability to create new less-liquid securities surely outpaces any regulatory body's ability to label them. Thus, any cap on these securities is a bit of an illusion. Still, by publicly suggesting that open-end funds are not the preferred vehicle for less-liquid securities, the SEC may help push these investments to vehicles such as closed-end or interval funds, which, because they do not offer investors the promise of daily redemptions, are more appropriate for such activities.

Finally, I think the pressures that tempt fund managers to take greater risks should be addressed. Much of this pressure, of course, owes simply to competition. With more funds and increased media coverage, fund managers are under tremendous pressure to perform. To a degree, that's healthy. What's problematic is the unevenness of the playing field on which these managers compete. If managers are judged on a level playing field, it is relatively easy for spectators to assess performance accurately. Unfortunately, due to the increased use of 12b-1 fees--fees that tack marketing expenses onto a fund's operating expense ratio--many fund managers are placed at a material disadvantage to their peers. It is relatively simple to leave front-end or deferred sales charges--two alternative means of

recouping marketing fees--out of a comparison between managers. It is far more difficult--and not the media's current policy--to extract fees that have been appended to the expense ratio in making such evaluations.

As management and operating fees are generally similar among funds with like objectives, the primary difference between high and low expenses is the level of 12b-1 fees. Curtailing the use of these fees would provide a more level playing field and strengthen the industry's health by separating management and marketing concerns. Currently, a manager assigned a fund with a high 12b-1 fee must take considerably more risk than he or she would take with a lower-cost fund just to try to produce the same yield for a shareholder.

It is one thing for a manager to accept added risk for investment reasons; it is something altogether different for a manager to take more risk to overcome a marketing cost. Too frequently, these added risks have gone awry and have come back to hurt investors. The SEC can't and shouldn't regulate away risk-taking, but it can seek to ensure that the risks taken in a portfolio are taken for investment reasons, not to compensate for marketing costs that have been inserted into the investment equation.

Conclusions

These suggestions won't guarantee that no investor will take inappropriate risks in the future, but they will help ensure that the playing field on which they operate remains well-lit and free of unnecessary obstacles. I'd like to thank the committee for the opportunity to participate in this public discussion on mutual funds. I eagerly await the opportunity to answer any questions you may have of me. Thank you.

Mr. MARKEY. Thank you very much, Mr. Phillips.

Mr. Fink, in the past, many of the ICI's members have felt quite strongly that the industry would be negatively affected if a money market fund broke a dollar. What is the prevailing view today?

Mr. FINK. I think the prevailing view is it depends in what circumstances and which kind of fund. So I think there is no universal answer to that.

Mr. MARKEY. So what is your view of the decision to liquidate this fund?

Mr. FINK. That particular fund?

Mr. MARKEY. Yes.

Mr. FINK. I think it is a very isolated case with an isolated—I think somebody said 113 or so shareholders, institutions. It strikes me as fairly ho-hum.

Mr. MARKEY. Ho-hum. Do you think there is any likelihood that there are other funds that don't have just 114 but thousands of investors that could be in a similar situation right now?

Mr. FINK. Not that I know of. Anything is possible, but I would doubt it.

Mr. MARKEY. You would doubt it.

Mr. Attorney General, of the many different issues associated with derivatives and mutual funds, perhaps none caused me as much concern as those associated with the use of leverage.

First, do you believe that some fund managers are using derivatives intentionally for the purpose of circumventing the spirit, if not the letter, of the 1940 Act's restrictions on leverage? And second, the 1940 Act addresses the issue of leverage principally through restrictions on the issuance of senior securities. Does this leave potentially serious gaps in our regulatory scheme?

Mr. KOPPELL. Well, first the answer to the first question is yes. That is, I think that they are using leverage inappropriately. And the second question I didn't quite follow, if you would repeat it.

Mr. MARKEY. It is the question of whether or not the 1940 Act addresses the issue of leverage principally through restrictions on the issuance of senior securities. Does this leave potentially serious gaps in our regulatory scheme?

Mr. KOPPELL. I can't answer that question off the top of my head. I will respond to you by letter on that because I can't answer that.

I think that the key issue, as I tried to indicate in my testimony, is that we have increasingly seen the use of derivatives as leveraging devices, attempts by the fund managers to increase rates of return, and the fact of the matter is that these funds are not intended for that purpose, and with the increase in interest rates particularly, and also with decreases in interest rates, leverage, depending on how it is used. has very substantial consequences with respect to the value of the investments.

And as I said, first of all, it clearly jeopardizes the market value and the market value of the investment as we go along, but it is so substantially used that it even jeopardizes the longer term value of the funds.

Mr. MARKEY. Thank you.

Mr. Phillips, do you agree that investors often develop general expectations about mutual fund risk based on how their fund is categorized and may not understand or even read disclosures bur-

categorized and may not understand or even read disclosures buried in the prospectus? And similarly, don't investors have a right to expect that a short-term government bond fund will be relatively safe and a very cautious investment?

Mr. PHILLIPS. I think both of those statements are true and the message that comes across to someone who looks at the marketing materials for a short-term government bond fund, which has a picture of the U.S. Capitol dome on the cover, is that this is a very safe, secure investment, and investors are particularly wary about doing the leg work and understanding the risk, especially the investors today that are the ones that are perhaps more reluctant investors, those that have had to be coaxed out of the money market funds, which are perhaps their preferred investment vehicle.

Mr. MARKEY. Now, many of the derivatives problems experienced by funds, Mr. Phillips, have flowed from instruments known as collateralized mortgage obligations. Although it may seem laughable at this point to give a fund a name like the derivatives fund or the mortgage-backed securities fund, wouldn't those be more accurate and more honest descriptions of the fund and the fund's category?

Presumably, we laugh at the thought because few people would now consider investing in such a fund, but isn't it likely that even today some investors are putting their money into funds that largely are unknown to them as heavily invested in exactly those types of derivatives and which would be highly unlikely investments if they had a name on top of them that reflected what was built into them as risk?

Mr. PHILLIPS. Not only is it likely that people are doing that; it is almost certainly the case, and you are right. Fund marketing tends to highlight the most comforting features of a mutual fund. It tells you what can go right with an investment. But for people to succeed with mutual funds and to invest successfully, they have to be able to assess what might go wrong with that investment, what is a worst case scenario and what are the real risks that I am taking, and those are the kinds of things that naturally, through the marketing attempts at mutual funds, tend to get short shrift, and yet they are vital to an investor's success.

Mr. MARKEY. Now, Mr. Fink, do you agree that there are funds that are misadvertised in terms of their content, the risk that is inside of the fund itself as opposed to how it is marketed to the unwary investor?

Mr. FINK. I have never done a survey of names and marketing materials. Taking Mr. Koppell's things at the face, it appears there are funds that misdescribed, who were making investments the investor would not expect, assuming his information is correct.

Mr. MARKEY. Assuming that his information is correct and that Mr. Phillips' analysis is correct as well, what should we do to ensure the investor is getting what he or she bargained for, which is a relatively risk free investment?

Mr. FINK. I think first of all, the first thing is to govern sales practices and sales literature. I don't think anybody on the panel has a problem with a fund investing a lot in CMO's provided the risk is explained to investors. It seems the major problem is one of marketing and misdescription. That is something the SEC, the

State regulators, the NASD ought to be working on. If you describe yourself as a short-term government bond fund with a picture of the United States Capitol, your investments ought to comport with that.

Mr. MARKEY. So if someone doesn't have time to go to Las Vegas and they just want to put all their money into exotic derivatives funds, that should be their right and no one should try to convince them they shouldn't go there, anymore than they should go to Las Vegas, but let's not have the widows and orphans thinking that this is the fund for them if they are just substituting something for putting the money under the mattress. That is a different kettle of fish altogether, and right now it is very difficult for the ordinary investor trusting advertisements to make that kind of distinction.

Mr. FINK. Yes. I think when you go through not only Mr. Koppell's but the cases that have been in the newspapers, they strike me as more misdescription and marketing than anything inherently wrong about the investments. They just were different investments than people expected.

If I could expand on an earlier question about the money market fund, I didn't mean to make light of it. I meant to say it is a case-by-case instance, and this particular one, given its shareholder base, the kind of fund it was, I think the industry is not very concerned about.

Mr. MARKEY. I appreciate that. There is a canary-in-the-mine-shaft quality to it that, unfortunately, too often in our experience has been just a Cassandra-like warning that more is about to occur, that others are out there in a similar condition, and it is not a sui generis condition. We don't have knowledge one way or the other, but I have an arched eyebrow of concern.

Mr. FINK. I might say also, we have always been very strong supporters of disclosure, cover-page disclosure of investors in every ad that gives performance for a money market fund, stressing it is not insured or guaranteed. While you hate to see investors get injured, if it is a lesson to the investing public, generally it might not be a bad thing.

Mr. MARKEY. The issue is there may be a warning but the investor may not have the capacity of understanding what is inside of their mutual fund because there has not been full disclosure. In other words, they would have to go to extraordinary lengths to disaggregate the component parts of the fund they are invested in.

Mr. FINK. As Chairman Levitt said, 2a-7 is a very tight band. If the funds are conforming to the rule, there is not much of a band for differentiation.

Mr. MARKEY. Has the ICI been monitoring the level of redemptions of those funds which have experienced sharp losses? Have redemptions been on the rise at those?

Mr. FINK. We have periodically, not systematically. If someone would bring it to my attention, I believe, if there were some huge redemption problem.

Mr. MARKEY. Would a high redemption rate raise investor protection issues?

Mr. FINK. Not necessarily. If the fund held liquid securities and would sell them into the market at their price, it shouldn't make any difference.

Mr. MARKEY. Let me turn and recognize the gentleman from North Carolina, Mr. McMillan.

Mr. MCMILLAN. I thank the chairman.

Mr. Fink had heavy duty this week. He had to testify before the Entitlement Commission on Friday on savings rate and so forth. So I appreciate your coming back up here again.

There seems to be a little different perception between you and Mr. Phillips, particularly as to the scope of derivatives and the impact on the market. You made reference to relatively minor commitments by funds. Do you have that in some sort of table or physical analysis that could be made available to the committee?

Mr. FINK. Certainly. Last winter at the end of 1993, we did a survey of all mutual funds other than money market funds. It is summarized in our testimony. Basically, industrywide there was relatively a low level of derivatives by nonmoney market mutual funds. That doesn't tell you if things have changed since that time and it also doesn't tell you about individual funds. But if you took equity funds and bond funds as a whole, as of that point of time, to us it was a surprisingly low number.

Mr. MCMILLAN. Do you, Mr. Phillips, have a different perception as to the scope or degree of use of derivatives?

Mr. PHILLIPS. I don't believe that taking the use of derivatives and then dividing that by a base of all mutual funds gives you a realistic idea of the problem. What we are talking about with derivatives and how they have changed the risk-reward parameters of some government bond funds is very extreme.

Derivatives greatly alter the risk-reward trade-off in a fixed income fund. They would not have nearly as large an impact in an equity fund where you are already taking a lot of market risk in individual securities. So what is of importance is the degree to which they have changed the risk-reward parameter of investments that the public thought were especially low risk.

When the public buys an aggressive growth stock fund, it expects a certain degree of variability. When it buys a bond fund, especially a government bond fund and extra specially a short-term U.S. Government Bond fund, it expects great stability and the derivatives have added an additional element of the unknown to that picture.

What can often be the case is that a fund that historically has been low risk and followed those parameters has now started to put derivatives into the mix and that has greatly altered the risk-reward trade-off that an investor might assume that he or she is taking when they purchase the fund.

Mr. MCMILLAN. From what you have heard, do you think that the voluntary methods that have been suggested by Mr. Levitt and others would be sufficient to address this question in terms of investor awareness of what changes may be occurring or what commitments are being made by individual funds?

Mr. PHILLIPS. I think if the information is out there systematically for all funds through uniform disclosure, there is enough public pressure right now to know which funds are taking what risks and that you would get independent organizations making their own assessment of the risk level of different funds. I think it is problematic for a government agency to step in and say we consider these securities to be high risk and these to be low risk. I

think it is much better to allow a public debate where people draw the line in different places and give the public more vigorous debate as to which risks are occurring in which fund. That is why I called for more uniform disclosure of the fund portfolio holdings, so that this analysis can go on.

Mr. McMillan. I don't think Mr. Levitt was suggesting that the government try to do the risk appraisal.

Mr. Phillips. In a sense, though, that is the case, if you are trying to put a cap on what is the percentage of illiquid securities, because Wall Street's ability to come up and derive new illiquid securities, new derivatives may outpace a government agency's ability to say these securities are proper and these aren't. Any cap is somewhat of an illusion, whether it be at 15 or 10 percent.

Mr. McMillan. Some others may want to respond to that, but I would like to ask you a question having to do with the likelihood that the industry itself is going to respond with a rating of its own risks, as it perhaps attempts to do in other debt securities, for example. Did you want to respond?

Mr. Koppell. The products are becoming so sophisticated and divorced from what we normally think of as securities that it becomes very difficult. I think one of the things Mr. Phillips said was interesting, where they disclosed that they were buying floating rate notes but they were in fact inverse floaters.

We have a, new to me anyway, instrument called a structured note, which is a note where the interest rate or the return, if you will, is based not on a customary interest rate but may be keyed to an index, a futures index or a currency index. These are complex and so difficult to define that I would suggest it is very difficult for anyone reading even a list of the investments of a particular portfolio to understand exactly what kind of risks they are buying into.

If the note's return is based on, say, cattle futures or pork belly futures or corn, it is very hard to tell exactly what risk you are buying into. That is why merely publishing a list of the investments alone may not be sufficient really to protect people or to inform people very well.

Mr. Fink. I think we have two audiences and two avenues here. One is the detailed information that Mr. Phillips would like because knowledgeable people like Mr. Phillips can manipulate and can analyze the information. That is one good route. He reaches a lot of investors.

But the second route is the opposite end of it, the investor who wants to do it him or herself, and there I am convinced that less is more, that the lengthy prospectus is unhelpful, it is confusing, and what would be better there would be the single one-page summary prospectus which would give the fund's expenses, its objectives, its risks and with consideration, as the SEC has proposed, of some kind of risk measurement—might be duration, data, volatility, et cetera, or it might be all three of those. I think for the average person that would be a lot more useful, but I think there are two different routes to go, and I think they both get at the problem in opposite ways.

Mr. McMillan. I think that is a good point because that type of brief prospectus is something that is likely to be read and paid attention to.

Mr. FINK. If I can give an analogy, I happened to buy a new car 3 years ago. I know a lot about mutual funds and nothing about cars. I ended up with a 238 manual, like 15 pages to tell me how to tune my FM radio. My 16-year-old son can do it; it is hopeless for me.

When I looked at the cars, the most useful thing to me was to go to six places and look at the sticker on the side that says passenger seat, seat belts, price, miles per gallon. That is how I made my decision; with 10 key facts. I think that would be a lot better for one audience. I think the other audience Mr. Phillips and his competitors serve well.

Mr. MCMILLAN. We have requirements on general securities offerings with rather extensive disclosure and statements, and having been in the business, I would say that the percentage of those who read that prospectus before making a commitment is relatively small. I am not saying back up and don't do it. I think it needs to be done. But there is a short form way of alerting people to what they should be paying attention to, and I think we can give that some attention, and some suggestions have been made in that respect. And there should be some kind of signal in that process that alerts them that you better look more carefully at the nature of the risk involved in this investment because they are different and extraordinary from what you might think. I think there is a way to do that.

My question is do you see that forthcoming in the suggestions that have been made by Mr. Levitt and others that are going to be the subject of——

Mr. FINK. The simplified prospectus? I don't think Mr. Levitt mentioned it, but it had been proposed 2 years ago by the SEC and it has been criticized I think by a lot of people who don't understand it. I think it is kind of languishing, but I think the issue of derivatives and risk disclosure really highlights how useful it would be. I suggested one way to do it is start with a simple class of funds, take money market funds and let's have a rule with a 2-year life and let's see how it works with money market funds.

Mr. MCMILLAN. How about a simple statement that this fund as a matter of policy invests in derivatives?

Mr. FINK. You would have to explain about the risk of the derivatives or the overall risk of the portfolio.

Mr. MCMILLAN. But there are all kinds of risk. Some actually may be hedges that reduce risk. That is the way they are presented in many cases.

Mr. MARKEY. If the gentleman would yield, could we distinguish between hedging and exotic derivatives? Say as a rule of thumb that it is the exotic derivatives that need disclosure and that there has to be some recognition given to the speculative nature of those, and wall out the other 80 percent that unfairly get tarred with this brush and is used by the exotic derivatives as a shield against any disclosure of their activity?

Mr. MCMILLAN. Isn't what we are really concerned about a fund that may be a high-risk type of derivative investment portfolio, if that is what they wish to do and that is adequately disclosed, and that is the decision the investor needs to make. I think we are concerned that there are some funds that may be stretching their in-

vestment strategies in order to elevate their level of return relative to competition in ways that aren't disclosed because they don't want to disclose what they are doing. It seems to me that is what we should be concerned about if in fact that is going on.

Mr. MARKEY. Michael Milken wanted to call them high-yield bonds, but everybody else called them something else. They added junk on top. It kind of serves each one of us with a little confidence that the investor has an idea that this may be a bit more risky than buying a thousand shares of General Motors for their Godchild. It is that kind of a distinction that we haven't formalized yet and it came into being through just common usage that they would be called junk bonds and they fought it vigorously. We need a distinction between plain vanilla derivatives and derivatives that are beyond the ken of many individuals to prognosticate remotely accurately.

Mr. KOPPELL. Nothing you said is wrong, but I think there are several different questions. The first question—and I think Mr. Fink and I seem to agree that the advertisement of a lot of these funds is seriously deficient in telling people what they are buying.

The second question, and this applies to both closed-end and open-end funds, are the restrictions that exist adequate?

In other words, if the open-end funds are not supposed to be using leveraging techniques, as Mr. Fink suggests, are they doing that but not calling it that? Are they leveraging their investments? Are they taking larger risks than they should be taking, and is that being monitored?

I would suggest the fund that failed, that money market fund—the suggestion there is that they probably were doing something they shouldn't have been doing with the money market funds. I know Mr. Levitt didn't want to discuss that because it is part of his ongoing investigation. That I think raises a major question that ought to be analyzed. We are trying to analyze that from a New York perspective, but it should be analyzed from a national perspective, that is are these funds using these derivatives inappropriately given the regulatory scheme that exists now?

If not, then maybe the regulatory scheme ought to be tightened up, and things like structured notes, tying rate of return to futures' indices, shouldn't be used at all; they should be barred from ordinary mutual funds.

Mr. PHILLIPS. I think you are right that a line needs to be drawn. The difficulty is where to draw the line with securities that are so new and untested in the market place. Not all derivatives are bad. We should keep in mind that mutual funds themselves are derivative products. So clearly there is a place in the marketplace for derivatives.

The question is where do you draw the line. Some of these securities were thought to be liquid until push came to shove in a rising rate environment, and all of a sudden things that might have been classified as liquid securities suddenly became illiquid. That is why I am proposing that perhaps it not be the SEC drawing the line, saying these securities are acceptable and these aren't, but you have uniform disclosure of who holds what so that the public can draw that line and define what should be called high-yield, as you refer to, and what should be called junk.

Mr. McMILLAN. It seems to me where there is less certainty then there is higher risk and that is a red flag. It is not a negative, it says take a second look at what you are buying.

Mr. PHILLIPS. That is right. Third parties might not say these securities are good or bad but say that "X" percentage of this fund is in securities that are relatively new, untested and present an unknown.

Mr. FINK. I agree with Mr. Koppell, if people are misadvertising, that ought to be dealt with harshly, but I don't think we ought to outlaw instruments. Remember what mutual funds were designed for. The millionaire or pension plan or wealthy institution can hire a money manager and invest in anything, and the mutual fund is designed to give the average person the ability to invest in those same things, very conservative, moderately conservative, speculative or not.

As long as we are liquid, can be sold at the price that they are being priced at or diversified, I don't think the fact that they go up and down faster than other products, as long that is disclosed, I don't see why that product should not be on the market.

There is a technical question on what leveraged means. The Investment Company Act I believe said mutual funds can't leverage. I think that meant they couldn't lose more than they invested. If they bought something for $10, they could lose $10 and no more. I think these structured notes fit that definition; they can't lose more than they paid for the structured note. So I don't think these new instruments raise leverage problems. They are speculative but I think that is a disclosure matter, not a matter of leverage.

Mr. KOPPELL. I define leverage differently. If you define it your way, then I think it is an inadequate definition to protect people.

Mr. McMILLAN. You are unable to lose more than the value of the structured notes?

Mr. FINK. If you buy a note for $10 and it goes to zero, you have lost $10. If you leveraged, if you borrowed to buy it, true.

Mr. McMILLAN. But you are perhaps filing a statement that states what it is worth from time to time and therefore you have always got new information being put out as to what the value is.

Mr. FINK. I think when the Act forbade leverage, it didn't want funds to be able to lose more money than they invested. I don't think these instruments implicate that problem. That is all.

Mr. McMILLAN. I have no further questions.

Mr. MARKEY. The gentleman's time has expired.

I will ask each of you to give us a 1-minute summation of what you want us to retain on the subcommittee.

While you are thinking about it, Mr. Phillips, how old are you?

Mr. PHILLIPS. I am 32.

Mr. MARKEY. And you founded Morningstar?

Mr. PHILLIPS. No. Gilman Slater founded Morningstar. I was initially the publisher.

Mr. MARKEY. When did you become the publisher?

Mr. PHILLIPS. I was our staff of in-house analysts in 1986. I was just out of graduate school.

Mr. MARKEY. You were 24?

Mr. PHILLIPS. Yes, sir.

Mr. MARKEY. You were Morningstar?

Mr. PHILLIPS. I was Morningstar.

Mr. MARKEY. That is very impressive.

It takes a quant to know a quant. You have to have somebody who understands what they are doing.

Mr. Attorney General?

Mr. KOPPELL. My summation is number one, that the use of these derivative and exotic, if you will, investments by mutual funds poses, in my view, a serious threat not only to the investors who invest but to the confidence in the capital markets in this country and the tens of millions of people who are putting their savings into these investments, so it is a matter of great concern. I think there is an absolutely critical need to overhaul the disclosure with respect to what is being sold.

I also believe—and I think this session has actually convinced me more—of the need to more closely both monitor what these funds are doing and indeed control some of their investment activities. I am not convinced that disclosure alone will solve the problem, and perhaps there should be one type of investment available that says that this is a very high risk or its risk cannot be quantified and there we need to be less concerned because the average investor will know that they are taking tremendous risk. But in those mutual funds that are sold as mutual funds, the use of these derivatives I think should be severely limited if not eliminated, except for strict hedging purposes which is carefully monitored.

Mr. FINK. I guess I will differ with my classmate.

Mr. MARKEY. From where.

Mr. FINK. Harvard Law School.

I think derivatives can be good or bad, and it depends how they are used. They cover a gamut of things. When Congress drafted the Investment Company Act, I think it gave the SEC the tools to deal with almost everything that comes along. Remember, all we had were equity funds in 1940. Money market funds didn't start until 1972. Bond funds did not start until in 1979. Funds investing in foreign securities didn't start until some other date. Derivatives are a new problem. But I think the existing system can deal with it if it is refined.

To go back to our testimony, disclosure can be made better. There should be disclosure about the fund as a whole, including risk measurements. Financial statements could be better. It just says a note, doesn't tell you anything about it. We are all for that. The NASD must police sales literature, the kinds of things Mr. Koppell had in his investigations, and sales practices by brokers and banks and others. Most important, the summary prospectus; less is more.

In the substantive area, I would decrease the 15 percent test to 10 percent and I would give the SEC more money so the SEC can be out on patrol and can see that things can be enforced. I don't think we have a crisis, but I think it can be dealt with now before we have more problems.

Mr. MARKEY. A rule of thumb under which I operate is that, since the founding of the Republic, on every major public policy issue, a Harvard Law School graduate has been on the wrong side of that issue. The task for the country is to figure out which Har-

vard graduate is on the wrong side of that issue, but without question one always is.

Mr. Phillips.

Mr. PHILLIPS. Noting that mutual funds have become the vehicle of choice for investment for a whole generation, that is why I think these hearings are so appropriate. I think at the same time that investors are embracing mutual funds, the definition of what a mutual fund is is evolving rapidly.

One of two things must happen. Either there must be very intense education in the public through full disclosure as to how this definition of what activities occur under mutual funds are, and to make sure that people know the evolving definition of mutual fund; and second, I think perhaps a line should be drawn as to what activities are acceptable in open-end mutual funds and which are not. Some investment vehicles, emerging markets, less liquid securities, some derivative activities, are frankly better suited for the closed-end arena or perhaps for the interval fund where the promise of daily redemptions is not as strong. Some consideration should perhaps be given to which investment vehicle is appropriate for which investments.

Mr. MCMILLAN. Could I ask Mr. Phillips one question?

Did you attend Harvard Law School?

Mr. PHILLIPS. No, sir, I did not.

Mr. MARKEY. You stand in all of our shoes for daily monitoring of activities in this marketplace.

I want to thank each of our witnesses for their testimony. We have discussed a significant number of delicate issues related to derivatives and losses at some mutual funds. Overall, I think that we agree on many more issues than we disagree about, and I am particularly pleased by the enthusiasm for reevaluating the way in which we inform investors about the risk in various funds.

I look forward to working with other members of the subcommittee in the weeks ahead as we try to put together a package that would deal with the needed information that has to be put in the hands of all investors.

With that, this hearing is adjourned.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[The following material was received for the record.]

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

September 26, 1994

The Honorable Edward J. Markey
Chairman
Subcommittee on Telecommunications and Finance
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Jack Fields
Ranking Republican Member
Subcommittee on Telecommunications and Finance
Committee on Energy and Commerce
U.S. House of Representatives
2125 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Markey and Representative Fields:

Thank you for your letter dated June 15, 1994 concerning mutual fund use of derivatives. Your letter raises a number of important questions concerning the framework for the regulation and oversight of these activities. I share your concern for these important investor protection issues, and am particularly committed to finding improved ways for funds to communicate to shareholders the risks of investment.

Your letter requested that the Commission undertake a comprehensive study of the use of derivatives by mutual funds. I am enclosing a memorandum prepared by the Division of Investment Management that comprises the requested study.

Mutual funds are the investment vehicle of choice for funding Americans' essential needs -- for educating their children, for retiring with dignity. The Commission considers the protection of mutual fund investors absolutely essential. We have been, and will be, vigilant in addressing the issues raised by mutual fund use of derivatives, and we look forward to working with you in this endeavor.

Sincerely,

Arthur Levitt
Chairman

Enclosure

MEMORANDUM

September 26, 1994

TO: Chairman Levitt

FROM: Division of Investment Management BRB

RE: Mutual Funds and Derivative Instruments

This memorandum responds to a letter dated June 15, 1994 (the "Letter"), from Edward J. Markey, Chairman, and Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce ("Subcommittee"), requesting that the Commission undertake a study of the use of derivatives by mutual funds and, more particularly, the adequacy of laws and regulations governing their disclosure and use. The Letter raises questions about (1) Commission knowledge of mutual fund use of derivatives, (2) disclosure of mutual fund use of derivatives, (3) the effect of mutual fund competition on derivatives use, (4) mutual fund pricing of derivatives, (5) liquidity of derivatives held by mutual funds, (6) leverage available to mutual funds through derivatives, (7) risks faced by investors in bank-advised mutual funds, and (8) derivative use by money market funds.

As you are aware, investor protection issues raised by mutual fund use of derivatives have received heightened attention by the Commission since you became Chairman. You have urged fund directors and trustees to exercise meaningful oversight of fund derivative investments and have encouraged the management of every fund using derivatives to manage their derivatives risks effectively. In addition, you have directed the Division to make mutual fund use of derivatives a priority -- in the disclosure review process, in fund inspections, and in policy considerations. In responding to the Letter, this memorandum also reviews the steps taken to date by the Commission and the Division to address investor protection issues raised by mutual fund use of derivatives and describes the further actions that the Division recommends.

Background

A. The Use of the Term "Derivative"

The term "derivative" is generally defined as an instrument whose value is based upon, or derived from, some underlying index, reference rate, (*e.g.*, interest rates or currency exchange rates), security, commodity, or other asset.[1] "Derivative" may cover a wide variety of instruments,[2] and public debate concerning issues raised by derivatives is

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[1]*See, e.g.*, GROUP OF THIRTY GLOBAL DERIVATIVES STUDY GROUP, DERIVATIVES: PRACTICES AND PRINCIPLES 2 (July 1993) [hereinafter G-30 REPORT].

[2]The term "derivative" generally is used to embrace forward contracts, futures, swaps, and options. *See, e.g.*, *id.* at 28-34; U.S. GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM 5 (May 1994). The term is also commonly used to describe instruments that are created by separating other financial instruments into constituent

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often complicated by imprecision regarding the instruments that raise a particular issue. Indeed, the public debate about "derivatives" sometimes suggests that a "derivative" is any complicated instrument that has caused losses. Mutual fund investments in derivatives raise significant investor protection concerns, which are addressed in this memorandum, but these concerns typically relate to specific instruments used by specific funds and not to all derivatives and all funds. Derivatives may be standard or customized, traded on an exchange or over-the-counter, liquid or illiquid, novel or familiar, leveraged or unleveraged. Derivatives may increase or reduce portfolio risk. As the Subcommittee and the Commission continue to address the important issues raised by mutual fund use of derivatives, it will be important in each case to focus on the specific parameters of the problems to be addressed.

B. Mutual Fund Use of Derivative Instruments

Mutual funds, other than money market funds, use derivative products for a wide variety of purposes, including hedging interest rate, currency, and other market risks; substituting for a direct investment in the underlying instrument; or increasing returns. Money market funds also invest in debt instruments sometimes referred to as derivatives that have interest rates that are adjusted periodically based on changes in market interest rates. Many non-money market funds have the authority to use derivative instruments, but the Division's inspections to date suggest that the use of derivatives by most of these funds is limited. There are exceptions, however, to this general observation. Funds primarily investing in mortgage-backed securities, for example, generally have significant investments in derivatives. Long-term municipal bond funds use derivatives to seek increased tax-exempt returns. In addition, funds investing internationally may use derivative investments to lessen currency risks.

A recent industry survey of non-money market funds also suggests that mutual fund use of derivatives is limited.[3] The survey reported that the total market value of all derivatives held by participating funds was $7.5 billion, representing 2.13% of the total net assets of all funds reporting derivatives holdings and 0.78% of the total net assets of all funds participating in the survey. The total notional amount of these derivatives was $54.3 billion, representing 15.51% of the total net assets of all funds reporting derivatives holdings and 5.67% of the total net assets of all funds participating in the survey.[4] The survey also indicated that the level of use of derivatives varied by fund type, with fixed income funds accounting for 84% of the total market value of all derivatives held by reporting funds and 62% of the notional amount.

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pieces, *e.g.*, mortgage derivatives. *See, e.g.*, James K. Glassman, *Mortgages, and Governments, Can Get Sliced and Diced*, WASH. POST, Sept. 7, 1994, at F1.

[3]Investment Company Institute, Derivative Securities Survey, Feb. 1994. Survey respondents included 52 fund complexes with 1,728 non-money market funds holding aggregate net assets of $958 billion (76% of industry assets in non-money market funds). The survey was limited to a quantitative investigation of the use of derivatives by mutual funds and did not attempt to measure associated risks. *Id.* at 1.

[4]"Notional amount" was defined in the survey as "the maximum theoretical exposure presented by the instrument, *i.e.*, the amount whose *changes in value* impact the fund's net asset value." *Id.* at 2.

C. Investor Protection Concerns and Commission Actions

Although the use of derivatives by mutual funds generally appears to be limited, some funds have recently experienced problems relating to derivative investments. Several short-term government bond funds have experienced significant losses from mortgage derivatives.[5] In addition, losses in the value of certain adjustable rate notes held by some money market funds have resulted in the funds' advisers electing to take actions, including contributing capital or purchasing instruments held by the funds, designed to prevent the funds' per share net asset values from falling below $1.00.[6] Although the reported problems to date have affected a limited number of funds and fund types, they raise investor protection issues that merit serious consideration.

As you are aware, months before these reports surfaced, the Commission expressed concern about investor protection issues raised by mutual fund investments in derivatives. Since the summer of 1993, the Commission has taken a multi-faceted approach to mutual fund use of derivative instruments, focusing on a broad range of issues, including disclosure, pricing, liquidity, leverage, and risk management. A Division task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types, and the Division's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses. In addition, the Division's inspection staff is examining and reporting on the derivatives activities of each fund inspected, and has conducted special examinations of certain funds holding significant positions in derivatives.

D. Division Recommendations

This memorandum makes a number of recommendations for further action by the Commission to address mutual fund use of derivatives. The principal recommendations are the following:

- The Commission should consider requiring some form of quantitative risk measure in mutual fund prospectuses and should seek public comment on this topic no later than early 1995.

- The Commission should promptly consider reducing the ceiling on fund illiquid holdings. In addition, the Commission should continue to evaluate liquidity and pricing issues raised by derivatives through the mutual fund inspection process. If it appears appropriate as a result of these inspections, the Commission should consider issuing rules to address matters such as proper procedures for mutual fund pricing and liquidity determinations.

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[5] *See, e.g.*, Robert McGough, *Piper Jaffray Acts to Boost Battered Fund*, WALL ST. J., May 23, 1994, at C1; Andrew Bary, *Derivatives Undo a Popular PaineWebber Fund, Triggering 4% One-Day Drop in Value*, BARRON'S, May 16, 1994, at MW12 [hereinafter *PaineWebber Fund*].

[6] *See, e.g.*, *A History of Stepping up to the Plate*, FUND ACTION, Sept. 12, 1994, at 9 [hereinafter *Stepping up to the Plate*].

- The Commission should reexamine the application of the leverage restrictions of the Investment Company Act of 1940 ("Investment Company Act" or "Act")[7] to derivative instruments and should seek public comment on whether regulatory and legislative solutions are necessary to address the leverage created by mutual fund use of derivatives.

- The Commission should recommend that Congress enact legislation to enhance the Commission's ability to obtain information required to monitor fund use of derivatives.

E. Management and Board Responsibilities

The Commission has a critical role to play in enhancing investor protection in the area of mutual fund derivative investments. As you have noted, however, responsibility for managing a mutual fund's derivative investments falls, in the first instance, on the fund's management and board of directors or trustees.[8] To that end, you have urged fund boards to exercise meaningful oversight of fund derivative investments by becoming more involved in portfolio strategies, risk management, disclosure and pricing issues, accounting questions, and internal controls.[9] In correspondence with the chief executive officers of the 80 largest fund complexes, you encouraged the management of every fund that holds derivative instruments to take steps that will ensure the proper understanding and effective management of derivatives risk.[10] The Division's inspection staff examines mutual fund management controls, and is giving particular emphasis to controls relating to derivatives risk. On the basis of our findings during inspections and discussions with fund industry participants, we will determine whether to recommend that the Commission consider rulemaking to encourage better mutual fund management controls of derivatives risk.

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[7]15 U.S.C. § 80a.

[8]Strong management controls are generally recognized as essential to monitoring and controlling the derivatives activities and risks of derivatives dealers and end-users. *See, e.g.*, Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Securities and Investments Board, OTC Derivatives Oversight 3-4 (Mar. 15, 1994); The Technical Committee of the International Organization of Securities Commission, Operational and Financial Risk Management Control Mechanisms For Over-the-Counter Derivatives Activities of Regulated Securities Firms (July 1994); G-30 REPORT, *supra* note 1, at 9-13; Investment Company Institute, Investments in Derivatives by Registered Investment Companies 4-6 (Aug. 1994).

[9]Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Fund Directors as Investor Advocates, Remarks at the Investment Company Institute Investment Company Directors Conference, Washington, D.C. (Sept. 23, 1994) [hereinafter Levitt Remarks, Directors as Investor Advocates]; Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Mutual Fund Directors: On the Front Line for Investors, Remarks at the Mutual Funds and Investment Management Conference, Scottsdale, Arizona (Mar. 21, 1994).

[10]Letters from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to chief executive officers of 80 largest fund complexes (June 16, 1994) [hereinafter Levitt Letters].

Responses to Questions Raised by the Letter

Set forth below are the questions contained in the Letter, followed by the Division's responses.

1. **Does the SEC Have Adequate Knowledge of Industry Practices**

   a. **Please identify the information needed by the SEC to fulfill its responsibilities.**

The Commission's responsibility with respect to mutual funds is to administer and enforce the Investment Company Act and other applicable provisions of the federal securities laws. Through its inspection and registration processes, the Division can and does monitor individual mutual fund policies and portfolios, including derivatives activities. The Investment Company Act requires funds to maintain and provide to the Commission records reflecting much of this information.[11] In addition, during the course of examinations, funds generally voluntarily provide the Division with additional documents and access to fund personnel and often make records available in electronic media. Information concerning a fund's investments in derivatives is also contained in the fund's registration statement and amendments thereto, which describe investment policies and practices, and semi-annual reports on Form N-SAR and reports to shareholders, which contain information about portfolio activities. The information needed by the Commission, much of which is generally available to it, includes the following:

- complete information concerning the purchase and sale of portfolio instruments (*e.g.*, date and time of trade, counterparty, transaction price, identity of instrument traded);
- detailed information concerning each portfolio instrument (*e.g.*, for mortgage-backed securities, cash flow projections, including prepayment assumptions with respect to underlying mortgages);
- information regarding portfolio strategies and the manner in which each portfolio instrument contributes to portfolio strategies (*e.g.*, identity of portfolio positions that hedge other positions);
- valuations of fund assets and liabilities; and
- information relating to fund risk monitoring, *e.g.*, analyses of fund performance under various market scenarios.

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[11]Section 31(a) of the Investment Company Act requires every registered investment company to maintain and preserve those accounts, books, and other documents that constitute the basis for its financial statements. 15 U.S.C. § 80a-30(a). Section 31(b) of the Investment Company Act provides that investment company records required to be maintained under section 31(a) are subject to examination by the Commission. 15 U.S.C. § 80a-30(b).

b. **What obstacles, if any, prevent the Commission from obtaining and processing this information?**

Resource constraints are the principal obstacle to improved Commission monitoring of mutual funds. Although the Division generally can obtain the information it requires to monitor funds, the scope and frequency of our inspections are severely constrained by available resources.[12] Aside from information contained in a mutual fund's periodic filings, our knowledge of the fund's investment practices, including its derivatives holdings, is no more current than our most recent inspection. In addition, the increasing use of derivatives and other complex portfolio strategies has heightened the Commission's need to hire, train, and retain a highly skilled mutual fund inspection force.

The recordkeeping, reporting, and inspections provisions of the Investment Company Act also impose some limits on the Commission's authority to obtain information required to monitor mutual funds. In practice, these limits often do not hinder the Commission's fulfillment of its responsibilities, but they may do so in some circumstances, including, for example, when a fund does not voluntarily cooperate with the Commission; when, in times of market stress, rapid access to fund information is important; when the unavailability of electronic records in a format usable by the Division interferes with an efficient inspection; or when a fund does not maintain records that, if available, would improve Commission understanding of the fund's operations. These limits are described in detail below.

We emphasize that most investment companies cooperate fully with the Division's inspection staff and produce not only records required to be kept under the Commission's investment company recordkeeping rules, but other requested records. Most funds also allow Division inspection staff to interview employees responsible for maintaining these records, as well as portfolio managers, who are in the best position to explain many fund investments. And many funds make their records available electronically.

i. **Recordkeeping Authority**

Section 31(a) of the Investment Company Act requires every registered investment company to "maintain and preserve for such period . . . as the Commission may prescribe . . . such accounts, books, and other documents as constitute the record forming the basis for financial statements required to be filed pursuant to [the Investment Company Act] . . . ."[13] This provision presents two potential limitations for the Commission, one relating to the scope of required recordkeeping and the other relating to the form in which the required records are kept.

First, as a general matter, the Commission may require investment companies to keep records forming the basis for the preparation of financial statements. These records alone, however, often do not provide the Commission with enough information to evaluate the portfolio strategies that may underlie a mutual fund's use of derivatives. For example, these records may not disclose the relationships among portfolio instruments, *e.g.*, the identities of positions that hedge other positions. Nor is it clear that they include records

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[12] *See, e.g.*, Testimony of Arthur Levitt, Concerning Appropriations for Fiscal Year 1995, Before the Subcommittee on Commerce, Justice, and State, the Judiciary, and Related Agencies of the Senate Committee on Appropriations 4-6 (May 5, 1994).

[13] 15 U.S.C. § 80a-30(a).

related to portfolio management strategies, such as computer models that funds may use to evaluate the expected volatility of a specific derivative or the portfolio as a whole or the records generated by these models.[14]

Second, the Investment Company Act's recordkeeping provisions do not specifically address the medium in which records are required to be kept. In particular, the Commission would like specific authority to require that fund records be kept in an electronic medium.[15] Given the growth of the investment company industry, the size of individual funds, and the volume of transactions in which they engage, paper records are extremely cumbersome. Using paper records, the staff can only review a limited sample of the securities transactions in which a fund has participated over a specified period. Moreover, paper-based records do not facilitate modern examination techniques, such as computerized analysis to check for "red flags" that suggest the need for an inspection. Many funds voluntarily make their records available electronically, but fund records are not always maintained in an electronic format that is usable by the Division.

ii. Inspection Authority

Section 31(b) of the Investment Company Act provides that investment company records "required to be maintained . . . shall be subject at any time and from time to time to such . . . examinations by the Commission . . . as the Commission may prescribe."[16] This provision presents an issue that may affect the scope of the Commission's inspection authority.

Under section 31(b), there is no explicit requirement that funds provide records that are not required to be maintained under a specific provision of the Investment Company Act or Commission rules. The required records often cannot be understood without referring to other documents that are not required to be kept by Commission rules. These additional records, for example, may explain innovative products and investments. They may also provide important insights into the portfolio management strategies of a fund. At present, in the inspection context, the Commission often relies on voluntary fund production of these

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[14]The Division is currently preparing rulemaking recommendations that should increase the Commission's access to information concerning fund portfolios. For example, in light of the recent proliferation of derivatives and other novel financial instruments, the Division is reviewing the books and records rules to ensure that fund records are required to contain all information necessary to determine an investment's suitability for the fund and its value for the daily net asset value calculation. The Division previously recommended, and the Commission proposed, amendments to the recordkeeping requirements for money market funds that would require more detailed description of portfolio instruments. Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 19959, Part II.D.7. (Dec. 17, 1993), 58 FR 68585, 68604 (Dec. 28, 1993) [hereinafter Release 19959]. These amendments, when adopted, should facilitate the ability of the Division staff to identify instruments that have interest rate provisions that are inconsistent with the limitations imposed by the Commission's money market fund regulations. See the answer to question 8, below. The Division also intends to recommend revisions to Form N-SAR that should result in the Commission having more information concerning the nature of fund portfolios.

[15]In 1986, the Commission amended rule 31a-2 to permit investment companies to maintain their records electronically. 17 C.F.R. § 270.31a-2(f)(ii).

[16]15 U.S.C. § 80a-30(b).

records to examine fund transactions in investments that present novel investor protection issues, such as derivative instruments.[17]

iii. Frequency of Fund Reporting

Section 30(b) of the Investment Company Act authorizes the Commission to require a fund to file with the Commission "such information and documents (other than financial statements) as the Commission may require, on a semi-annual or quarterly basis, to keep reasonably current the information and documents contained in the [fund's Investment Company Act] registration statement . . . ."[18] The limitation to periodic reporting restricts the Commission's ability to monitor funds, particularly in times of market stress. For example, recent events have demonstrated that sudden changes in interest rates can have significant effects on fund portfolios that can be magnified by substantial derivative exposure.[19] The Commission is not now in a position to require prompt reports from funds on the effects of these interest rate changes, but must await the next periodic reports or initiate inspections.

c. What steps should be taken to insure that the Commission is able to obtain accurate and reliable information quickly and efficiently?

The Division recommends that the Commission seek legislative clarification and expansion of its existing authority to address the issues identified above. In particular, the Division intends to submit to the Commission recommended legislation that would do the following.

First, the Investment Company Act would be amended to authorize the Commission to require investment companies to "maintain and preserve such records as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[20] This provision would authorize the Commission to require any additional records that are necessary to enable its inspection staff, among other things, to analyze a fund's derivative investments.

Second, the Investment Company Act would be amended to expressly authorize the Commission to specify the medium and format in which records must be kept, including electronic media. Electronic recordkeeping in a usable format would enable the Division's inspection staff to review an entire portfolio at multiple points in time, and transaction flows

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[17]In the context of an enforcement investigation, the Commission may require the production of all records that may be related to the inquiry. *See, e.g.*, Investment Company Act § 42(b), 15 U.S.C. § 80a-41(b).

[18]15 U.S.C. § 80a-29(b). Currently, the Commission requires funds to file semi-annual reports on Form N-SAR. 17 C.F.R § 270.30b1-1.

[19]*See, e.g.*, *PaineWebber Fund*, *supra* note 5; G. Bruce Knecht, *Piper Manager's Losses May Total $700 Million*, WALL ST. J., Aug. 25, 1994, at C1 [hereinafter *Piper Fund*].

[20]This is the same grant of recordkeeping authority that Congress has provided the Commission with respect to broker-dealers in Section 17(a)(1) of the Securities Exchange Act of 1934 and investment advisers in Section 204 of the Investment Advisers Act of 1940. 15 U.S.C. §§ 78q(a)(1), 80b-4.

over time, to evaluate a fund's portfolio activities. This ability is particularly important in analyzing derivative investments, which are often used together with other instruments in the portfolio. Electronic recordkeeping would also facilitate the use of developing technologies that would make the Commission's investment company examination program more efficient. For example, if fund information were supplied electronically to the Commission's offices prior to an inspection, the inspection staff could analyze the data prior to commencing field work and target their efforts in the field on issues raised by that analysis.

Third, the Investment Company Act would be amended to require explicitly that fund provide the Commission with all records that are kept by an investment company, whether or not required by Commission rule to be kept.[21] Documents that are not required to be kept often provide the best description of the risks of a particular derivative instrument and may point to operational deficiencies.

Fourth, the Investment Company Act would be amended to authorize the Commission to specify the frequency of reporting by investment companies. This authority would assist the Commission by providing more timely access to information on fund portfolios and sales and redemption activity in times of market stress.[22] This authority would also enable the staff to obtain information that would help to identify particular funds or patterns of events that require closer scrutiny.

We believe that the legislation described above, if enacted, would increase the availability to the Commission of the data required to monitor adequately mutual fund investments, including investments in derivatives. We would emphasize, however, that, absent significant additional resources for the highly-qualified staff necessary to perform fund inspections and analyze available data, the Commission will remain constrained in its ability to monitor mutual funds even if the recommended legislation is adopted.

2. **Better Disclosure May be Critical to Help the SEC, but Will it be Accomplished in a Manner that Makes a Significant Difference to Average Investors?**

   a. **First, we suspect that investors often develop general expectations about risk based on how their fund is categorized, and would like to know if the Commission agrees.**

Neither the Commission nor the Division establishes, regulates, or gives guidance with respect to fund categories. Fund categories develop, over time, through use by the fund industry and rating services such as Lipper Analytical Services, Inc., and Morningstar,

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[21] *Cf.* Section 17(b) of the Securities Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. § 78q (making all records of broker-dealers subject to Commission examination); 12 U.S.C. § 248 (authorizing the Board of Governors of the Federal Reserve System to "examine at its discretion the accounts, books, and affairs of each Federal reserve bank and of each member bank and to require such statements and reports as it may deem necessary"); 12 U.S.C. § 481 (authorizing Comptroller of Currency to appoint bank examiners who "have power to make a thorough examination of all the affairs of national banks).

[22] *Cf.* Section 17(h)(2) of the Exchange Act, 15 U.S.C. § 78q(h)(2) (authorizing the Commission, in times of adverse market conditions, to require registered broker-dealers to make reports concerning the financial and securities activities of their associated persons).

Inc. As a general matter, certain categories of funds tend to be more or less risky than other categories. For example, among fixed income funds, a portfolio comprised of short-term bonds is normally less volatile than one comprised of long-term bonds. Acknowledging these general characteristics, investors presumably do develop general expectations about risk based on how their fund is categorized.

The Commission does regulate fund names, which often convey information about a fund's category. The Investment Company Act makes it unlawful for a registered investment company to use as part of its name any word that the Commission finds to be deceptive or misleading.[23] A Division guideline states that if a registrant's name suggests a certain type of investment policy, its name should be consistent with its statement of investment policy. The guideline also provides generally that if a fund's name implies that it invests primarily in a particular type of security, its investment policy should require that, under normal circumstances, at least 65 percent of the value of the fund's total assets will be invested in that type of security.[24] The Division also takes the position that where a fund has a name or investment objective that characterizes the maturity of its portfolio, the dollar-weighted average portfolio maturity of the fund must reflect that characterization.[25]

We would emphasize that a name, or any single piece of information about a mutual fund, cannot tell the whole story of mutual fund risk. The prospectus is a mutual fund's basic disclosure document. Fund prospectuses convey a range of information to investors, including the fund's name, investment objectives and policies, permitted investments, and risk descriptions.[26] This information, taken together, should communicate to investors a comprehensible and accurate picture of fund risk.

The Division is taking several steps to help ensure that a fund's name is consistent with the fund's use of derivatives and educate investors regarding the danger of relying too heavily on fund names. First, on an ongoing basis, in the review of fund registration statements, the staff looks for, and requests changes to, disclosure that is inconsistent with a fund's name. Second, because there are inherent limitations on the usefulness of fund names, the Division is undertaking consumer education efforts to alert investors to the need to read prospectuses and periodic reports and the danger of relying too heavily on fund names as the sole source of information regarding the fund's investments. Third, the Division is reevaluating the current requirements regarding fund names to determine whether they should be revised. In particular, the Division contemplates reevaluating the

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[23]Investment Company Act § 35(d), 15 U.S.C. § 80a-34(d). Under section 35(d), the Commission may bring an action to enjoin a registered investment company from using a materially deceptive or misleading name.

[24]Guidelines for Form N-1A, Guide 1. Commission rules restrict the use of the term "money market" in fund names. See section 8.a., below.

[25]Form N-7 for Registration of Unit Investment Trusts Under the Securities Act of 1933 and the Investment Company Act of 1940, Investment Company Act Release No. 15612 (Mar. 9, 1987), 52 FR 8268, 8301. The Division takes the position that fund portfolios must have the following dollar-weighted average maturities: short-term fund - not more than three years; short/intermediate-term fund - more than two years but less than five years; intermediate-term fund - more than three years but not more than ten years; intermediate/long-term fund - more than ten years but less than fifteen years; long-term fund - more than ten years. *Id.*

[26]Investment Company Act Form N-1A, Items 1 and 4.

requirements applicable to a fund whose name suggests that its portfolio is limited to instruments of a particular maturity. The Division also expects to review the use by funds of the word "government" in their names.

b. **Second, even if the fund's disclosures are presented clearly, concisely, and in a manner designed to maximize comprehensibility, it is still questionable whether investors would be able to understand and assimilate information that is useful to their investment decision. A discussion of how 'inverse floaters' work, or definitions of 'principal-only strips of CMOs,' will involve unavoidable elements of abstraction. Are there alternative ways of creatively presenting the critical information needed by investors, such as the effect on risk and volatility created by the fund's holdings of derivatives, that avoid the dilemma of attempting to define these instruments and strategies?**

Since the summer of 1993, the Division's fund disclosure review staff has given heightened scrutiny to derivatives disclosure in prospectuses; and a Division task force has examined the derivatives disclosures of 100 investment companies, representing a broad sample of complexes and fund types. We have found that funds generally provide investors with a list and technical description of instruments, including derivatives, that are permissible fund investments. Funds often describe the purposes for using particular derivative instruments (*e.g.*, to hedge currency risks), but typically provide only the most general information on the risk level of the fund taken as a whole or on how derivative instruments, taken as a group, modify that risk level.

The Division has advised mutual fund registrants that, in many cases, it has found fund disclosures regarding derivative instruments to be highly technical and has encouraged registrants to modify their existing disclosure to enhance investor understanding of pertinent risks.[27] The Division is also considering possible modifications of the Commission's disclosure requirements. In the Division's view, a potentially better form of disclosure may be some means of describing the risk profile of a fund's portfolio as a whole with greater specificity. This information would assist an investor in determining whether a fund's risk characteristics are consistent with his or her own investment objectives. Consumer focus groups conducted on the Division's behalf early this year indicated that investors may in fact find this information helpful.

In order to address investors' need for information about portfolio risk characteristics, the Division recommends that the Commission issue a release seeking public comment on whether mutual fund disclosure of some quantitative risk measure should be required and what that measure should be. This action would enable the Commission to obtain investor and industry input regarding the utility of various risk measures and the feasibility of their computation. A quantitative risk measure could have significant benefits for investors by providing a means of comparing risks across and within fund categories, particularly for fixed income funds whose market risks may be less well understood by investors than those associated with equity funds.

There are a number of quantitative risk measures that deserve consideration, and the comment process should help the Commission determine which, if any, of the available

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[27] Letter to Registrants from Carolyn B. Lewis, Assistant Director, Division of Investment Management (Feb. 25, 1994).

measures would be most helpful to investors and feasible for funds to calculate. The following are among the possibilities.

- Duration: a measure of the price sensitivity of a fixed income fund to changes in interest rates.

- Standard deviation: a measure of the volatility of a mutual fund's total return over specified time periods.

- Beta: a measure of a mutual fund's risk relative to the market.

We acknowledge that the selection of an appropriate risk measure is a difficult task because all measures have limitations. Most measures rely on historical data and can only estimate the level of risk that was incurred in the past, not what will happen in the future. In addition, measurements will change depending on the time period over which risk is measured and the benchmark against which a fund is compared. Some measures (*e.g.*, duration) are not applicable to all funds. And each measure would require investor education regarding the proper interpretation of the measure and its limited predictive value.[28]

c. **Finally, formal disclosure to investors takes place annually in the prospectus. But various derivatives positions, each with distinctly different possible risks, can change by the hour, or even by the minute. So it's not clear how much value there is in knowing what the fund held at a particular past moment in time. Does the Commission agree that this quality should be considered when evaluating the utility of requiring enhanced disclosure of derivatives holdings?**

The Division agrees that the fluid nature of the investment management process limits the utility of reviewing specific portfolio positions previously taken by a fund. Nonetheless, the Division believes that historical data does provide fund shareholders with important information.

A mutual fund is required to provide a schedule of portfolio holdings to its shareholders semi-annually.[29] This requirement ensures that shareholders receive a twice-yearly snapshot of a fund's investments. The snapshot is important in that it provides shareholders with a concrete, historical picture of how the fund has been managed.

The portfolio schedule is not, however, a complete guide to the portfolio manager's strategy. Other forms of disclosure help to enhance the picture. For example, non-money market mutual funds are required to include "Management's Discussion of Fund Performance" in their prospectus or annual report, discussing the investment strategies and

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[28]The standardized measures of fund yield and total return that are currently required to be disclosed in the prospectus are subject to similar limitations. Form N-1A, Item 22.

[29]Investment Company Act § 30(d)(2), 15 U.S.C. § 80a-29(d)(2); 17 C.F.R. § 270.30d-1; Form N-1A, Item 23; 17 C.F.R. §§ 210.6-05.1, .6-10(c)(1), .12-12.

techniques that materially affected fund performance during the preceding year.[30] Thus, a fund whose performance was materially affected by derivatives would be required to discuss that fact -- whether or not derivatives were reflected in the portfolio schedule at the close of the year. As another example, the use of quantitative risk measures, as described in the preceding section, could enhance investor understanding of a portfolio manager's strategy.

3. Is Intense Competition in the Fund Industry (or Any Other Reason) Leading Some Portfolio Managers to Move Risky Derivatives Into Otherwise Risk Averse Funds?

a. Is the competition for assets within the industry so intense that otherwise conservative funds take on disproportionate risks in order to outperform rivals?

In recent years, there has been tremendous growth in the number of mutual funds competing for investor dollars.[31] There have also been recent reports of significant losses by several short-term government bond funds, which generally are considered to be relatively conservative investments, and reports of losses on some adjustable rate instruments held by money market funds.[32] These facts, taken together, suggest that competition may, at present, play some role in encouraging mutual fund use of derivatives to enhance yield.

With more than 4,700 mutual funds competing vigorously for investor dollars, superior investment performance is one key way in which a fund can distinguish itself from rivals. Studies generally show, however, that it is much more difficult to maintain a high level of performance over a long period of time than over a short period of time.[33] Studies also show that investor money tends to flow toward funds with superior near-term performance.[34]

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[30]Form N-1A, Item 5A(a). Non-money market funds also are required to provide a graph comparing the fund's performance over the past 10 years with an appropriate broad-based market index. Form N-1A, Item 5A(b).

[31]In June 1994, there were 4,901 separate mutual fund portfolios, an increase of 769% from the 564 that existed at the beginning of 1981. Investment Company Institute Press Release, June Mutual Fund Sales Total $36.8 Billion, July 28, 1994; INVESTMENT COMPANY INSTITUTE, MUTUAL FUND FACT BOOK 101 (1993).

[32]*See, e.g.*, *PaineWebber Fund*, *supra* note 5; *Piper Fund*, *supra* note 19; *Stepping up to the Plate*, *supra* note 6.

[33]Michael C. Jensen, *The Performance of Mutual Funds in the Period 1945-1964*, 23 J. FIN. 23, 389 (1968); Edwin J. Elton, Martin J. Gruber, Sanjiv Das, & Matthew Hlavka, *Efficiency With Costly Information: A Reinterpretation of Evidence From Managed Portfolios*, 6 REV. FIN. STUD. 1 (1993).

[34]Erik R. Sirri & Peter Tufano, Competition in the Mutual Fund Industry, Paper Presented at Harvard Business School Colloquium, *Managing the Financial Service Firm in a Global Environment* (Aug. 26, 1992).

Thus, it would not be surprising if some mutual fund managers perceive pressure to take on additional risk in order to attain at least a short-term performance "boost."[35]

b. **Is the Commission concerned that the cause of the losses reported at two short-term government bond funds may represent a growing trend?**

It is unclear whether the recent losses by short-term government bond funds represent a growing trend. The losses reported to date, however, do not appear to be evidence of a systemic problem in the mutual fund industry. It is also worth noting that losses by mutual funds from strategies undertaken to boost current yield are not a new phenomenon, but, unfortunately, recur from time to time in various forms. In the 1980s, for example, similar problems were associated with so-called "government-plus funds."[36] In addition, the recent losses have been a forceful reminder to the fund industry that the upside rewards of assuming increased risk also carry downside penalties. This market lesson may significantly dampen industry enthusiasm for competition through assuming increased risk.

c. **Does the Commission believe that a legislative or regulatory response is needed to address any issues related to the derivatives losses reported at these funds?**

In general, competition within the mutual fund industry should be a positive force, encouraging funds to improve performance, lower costs, and reduce risks; and the Division believes that each individual mutual fund must determine how to respond to competitive market forces. We also believe that the regulatory structure established by the Investment Company Act, through the disclosure and fiduciary obligations it imposes, generally provides an adequate framework for ensuring that investors are adequately protected. A mutual fund, for example, is currently required to disclose to investors material information regarding the fund, including the risks of investing in the fund.[37] Accordingly, it is a violation of existing laws and rules for a fund to mislead investors materially as to its risk profile, including the effect that derivatives have on that risk profile.

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[35]A recent news article suggested that many fund portfolio managers have compensation arrangements with their employers that encourage them to take inappropriate risks. Robert McGough, *Taking Chances: Risk in Mutual Funds is Rising as Managers Chase After Bonuses*, WALL ST. J., Aug. 11, 1994, at A1. The Investment Advisers Act of 1940 prohibits most types of performance fees for registered investment advisers, but this prohibition does not apply to the compensation arrangements that investment advisers have with their employees, including mutual fund portfolio managers. Investment Advisers Act § 205(a)(1), 15 U.S.C. § 80b-5(a)(1). The Division is not persuaded that there is sufficient evidence of abuse to support extending the performance fee prohibition to mutual fund portfolio managers at the present time. At the same time, however, we believe that fund managers and boards of directors or trustees should review portfolio manager compensation arrangements to ensure that they are designed with sufficient controls and other oversight mechanisms to protect the interests of fund shareholders. *See* Levitt Remarks, Directors as Investor Advocates, *supra* note 9, at 8-9.

[36]*See, e.g.*, Jane Bryant Quinn, *No Place to Hide*, NEWSWEEK, May 11, 1987, at 62 (use of options to boost income on portfolio of government bonds at potential cost of diminished capital).

[37]*See, e.g.*, Securities Act § 17(a), 15 U.S.C. § 77q(a); Exchange Act § 10(b), 15 U.S.C. § 78j(b); Exchange Act rule 10b-5, 17 C.F.R. § 240.10b-5; Form N-1A, Item 4(c).

The Division believes, however, that the risks assumed by some funds that use derivatives to enhance performance could be better disclosed to shareholders. Funds are presently required to disclose significant quantitative information in the areas of performance[38] and costs[39], and the Division is recommending that the Commission consider requiring disclosure of some form of quantitative risk measure in mutual fund prospectuses. This is discussed in greater detail in response to question 2.

4. Are Mutual Funds Experiencing Problems Pricing Exotic Derivatives?

a. Pricing requirements

Mutual fund share pricing policies and practices are governed generally by sections 2(a)(41) and 22(c) of the Investment Company Act and rules 2a-4 and 22c-1 thereunder.[40] Section 22(c) provides the Commission with the authority to make rules governing the methods for computing the prices for mutual fund shares. Rule 22c-1 provides in part that a mutual fund may not sell or redeem its securities "except at a price based on the current net asset value of such security which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security."[41]

Rule 22c-1 generally provides that the current net asset value of a mutual fund's securities must be calculated every business day during which an order is received either to purchase or redeem a share of the fund.[42] Section 2(a)(41) and rule 2a-4 require a fund to mark its assets to market in computing net asset value. In the marking to market process, market quotations are required to be used for those securities for which the quotations are readily available. For all other securities and assets, a fund is required to use fair values as determined in good faith in accordance with procedures approved by its board of directors or trustees.[43]

b. Pricing v. price reporting

Before addressing the issue of mutual fund pricing of derivative investments, we believe it would be useful to distinguish between pricing and price reporting.[44] Although the Investment Company Act, and thus the Commission, regulate the *pricing* of fund shares in

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[38]Form N-1A, Item 2.

[39]Form N-1A, Item 3.

[40]15 U.S.C. § 80a-2(a)(41), -22(c); 17 C.F.R. § 270.2a-4, .22c-1.

[41]17 C.F.R. § 270.22c-1(a).

[42]17 C.F.R. § 270.22c-1(b)(1).

[43]15 U.S.C. § 80a-2(a)(41)(B); 17 C.F.R. § 270.2a-4(a)(1); Restricted Securities, Investment Company Act Release No. 5847 (Oct. 21, 1969) [hereinafter Release 5847].

[44]A fuller discussion of this issue appears in our August 22, 1994 Memorandum on Mutual Fund Share Price Reporting, responding to a letter dated June 30, 1994, from Edward J. Markey, Chairman, and Jack Fields, Ranking Republican Member, of the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce.

the manner described above, neither the Investment Company Act nor the Commission regulates -- or even requires -- the *reporting* of share prices to the news media. The incident referred to in the Letter, the absence of a reported price in the morning paper for a fund with derivative investments, is not the subject of either federal law or Commission regulation and is a separate issue from the question of whether purchasing and redeeming shareholders receive the correct price for their shares. Although share prices may be unreported because they are not calculated in time to meet newspaper deadlines, and the presence of certain derivatives in a fund's portfolio may make it more difficult to meet publication deadlines, *this does not mean that investors receive an incorrect price upon redemption, or pay an incorrect price at purchase.*[45]

c. Pricing and derivatives

The obligation of a mutual fund to calculate daily net asset value accurately for purposes of share sales and redemptions is critical to investor confidence. If net asset value is incorrectly computed, purchasing or redeeming shareholders may pay or receive too little or too much, and the interests of other shareholders may be overvalued or diluted. The accurate valuation of each portfolio asset, including derivative instruments, is the foundation for computing fund net asset value.

Funds normally obtain market quotations from one or more sources, such as last sale prices reported by service vendors or bid and asked quotations supplied by market makers. Many derivatives may be priced in this manner. Exchange-traded derivatives, such as futures and exchange-traded options, for example, generally can be priced based on last sale prices or market quotations.

Prior to purchasing an instrument, derivative or otherwise, a mutual fund typically evaluates the availability of market prices for the instrument. If market quotations are not readily available for the instrument, the fund must be prepared to use fair value as determined in good faith in accordance with procedures approved by its board of directors or trustees. When a fund decides to purchase an instrument, it typically will have determined either that market quotations are readily available or that it can implement fair value procedures. This decision-making process acts as a brake on a fund's acquisition of an instrument when it is evident, from the outset, that pricing will be problematic.

Market conditions change over time, and a fund may find that an instrument that had readily available market prices when it was acquired ceases to have such price availability. This appears to have been the situation during recent months in the mortgage-backed

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[45]Chairman Levitt recently requested that the National Association of Securities Dealers, Inc. ("NASD"), and the Investment Company Institute ("ICI") address issues relating to fund price reporting. Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Joseph R. Hardiman, President and Chief Executive Officer, NASD, and Matthew P. Fink, President, ICI (June 28, 1994). The NASD and the mutual fund industry have taken some steps to alleviate the time pressures and technological problems that may result in reporting problems, including an extension of the NASD's price reporting deadline, and are considering others. *See* Letters from Joseph R. Hardiman, President and Chief Executive Officer, NASD, and Matthew P. Fink, President, ICI, to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission (July 13, 1994). We are monitoring further developments in this area and working with the NASD and the mutual fund industry to ensure that the reporting system serves the interest of investors in obtaining accurate price information.

securities market, where decreased liquidity has resulted in the deterioration of accurate market pricing information for some derivative securities -- such as certain collateralized mortgage obligations. In these circumstances, it may be more difficult to establish reliable prices.[46]

The changing nature of markets makes it difficult, if not impossible, to ensure that mutual funds will never purchase instruments that become illiquid and, consequently, difficult to price. Nevertheless, the statutory and regulatory pricing requirements discussed above, together with the liquidity requirements discussed in response to question 5, act as significant checks on mutual fund investments in instruments that are difficult to price. Indeed, fund sponsors face substantial liabilities for pricing errors. In those instances when fund transactions occur at incorrect prices, it is the Division's policy that errors should be corrected when discovered, and fund sponsors should reimburse shareholders who have experienced a material economic loss due to the errors. Fund sponsors' own economic interests therefore militate against significant use of instruments that will cause pricing problems.

In order to provide assurances of price accuracy, funds typically employ extensive control procedures. For many funds, the control process begins with the use of independent pricing services to value fund holdings. Because pricing services compete for business, it is in their best interests to provide accurate prices. At the fund level, validation procedures, tolerance checks, and other reviews are often employed to test and control the validity of pricing.[47]

The Division does not believe that legislative changes are needed at this time to address pricing issues raised by derivatives. The Division intends, however, to continue to evaluate pricing issues in our inspections and will perform targeted examinations to obtain more information on these issues. If appropriate, we will consider issuing rules to address proper procedures for pricing determinations.

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[46] *See, e.g., PaineWebber Fund, supra* note 5; Robert McGough, *Baird Fund Spurs Worries About Pricing*, WALL ST. J., Aug. 15, 1994, at C1 [hereinafter *Baird Fund*].

[47] For example, many funds employ automated exception reports that compare the current day's price for each portfolio instrument to the previous day's closing price and note any instrument that has changed by more than a preset limit. A second typical procedure identifies any portfolio instrument price changes that cause the fund's share price to move more than a preset amount. A third common procedure compares portfolio transaction prices to price quotations obtained from pricing services and/or dealers. A fourth procedure involves portfolio manager review of the "price make-up sheet," the detailed listing of each instrument held by the fund and the associated price.

At the share price level, changes in share price are compared to changes in comparable indices to assure reasonableness. Price changes that exceed preset levels must be reverified and explained before they are entered into the accounting system for share price computation. Fund pricing staff may also look for corporate actions, news stories, or other developments to explain price changes.

5. **Are Mutual Funds Experiencing Liquidity Problems Because of Exotic Derivatives?**

   a. **Does the Commission believe that some of the more exotic and volatile derivatives should be considered "illiquid?" Has the Commission considered whether the 15% rule should be applied to any types of derivative products?**

Section 22(e) of the Investment Company Act generally requires that a mutual fund make payment for redeemed shares within seven days after the tender of the shares.[48] Because mutual funds hold themselves out to investors as being prepared at all times to meet redemptions within seven days, it is essential that funds maintain investment portfolios that will enable them to fulfill this obligation. For this reason, and because the extent of redemption demands are not predictable, mutual funds must maintain highly liquid portfolios.[49]

The Commission has published a guideline requiring that mutual funds generally limit their investments in illiquid assets to 15% of net assets. The guideline limit is 10% in the case of money market funds.[50] An asset is considered "illiquid" if a fund cannot dispose of the asset in the ordinary course of business within seven days at approximately the value at which the fund has valued the instrument.[51]

On occasion, the Commission and the Division have taken the position that certain classes of instruments are generally illiquid.[52] Generally, however, the determination of whether a particular mutual fund asset, including a derivative instrument, is illiquid should be made under guidelines and standards established by the fund's board of directors or

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[48] 15 U.S.C. § 80a-22(e) This requirement does not apply during any period that (1) the New York Stock Exchange ("NYSE") is closed other than customary weekend and holiday closings or trading on the NYSE is restricted; (2) an emergency exists as a result of which disposal by the fund of securities owned by it is not reasonably practicable or it is not reasonably practicable for the fund fairly to determine the value of its net assets; or (3) the Commission permits for the protection of shareholders of the fund. *Id.*

[49] *See* Release 5847, *supra* note 43.

[50] *See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992), 57 FR 9828 (raising guideline for non-money market funds from 10% to 15% to facilitate capital raising by small businesses) [hereinafter Release 18612]; Letter from Marianne K. Smythe, Director, Division of Investment Management, to Matthew P. Fink, President, Investment Company Institute (Dec. 9, 1992) (clarifying that change in limit from 10% to 15% does not apply to money market funds); Release 5847, *supra* note 43, at 7.

[51] Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14983 (Mar. 12, 1986), 51 FR 9773, 9777; Guidelines for Form N-1A, Guide 4.

[52] Release 5847, *supra* note 43 (restricted securities generally illiquid).

trustees.[53] Examples of factors that may be taken into account in determining liquidity include (1) the frequency of trades and quotes for the instrument, (2) the number of dealers willing to purchase or sell the instrument and the number of other potential purchasers, (3) dealer undertakings to make a market in the instrument, and (4) the nature of the instrument and the nature of the marketplace in which the instrument trades, including the time needed to dispose of the security, the method of soliciting offers, and the mechanics of transfer.[54] Ultimate responsibility for liquidity determinations rests with the fund's board, but the board may delegate the day-to-day function of determining liquidity to the fund's investment adviser, provided the board retains sufficient oversight.[55]

The Division believes that particular derivative instruments may be illiquid under all or most market conditions. This will more likely be the case if a derivative is designed to meet the needs of a particular investor. Such a derivative, almost by design, would not have the broad market required to support a finding that the instrument is liquid. The liquidity of other derivative instruments, however, may vary depending on market conditions. An instrument that is liquid in one market environment may become illiquid in another market environment. This has recently been the case, for example, for certain collateralized mortgage obligations. Recent interest rate increases and full dealer inventories apparently caused markets for these instruments virtually to disappear, leaving previously liquid instruments illiquid.[56]

Fund management's obligation to make liquidity determinations is a continuing one in the case of instruments, including derivatives, whose liquidity may vary under different market conditions. If changed market conditions result in previously liquid portfolio holdings becoming illiquid, fund management should determine whether any steps are required to assure that the fund continues to meet the 15% guideline.[57]

We note that, in general, there is a close relationship between the liquidity of an instrument, derivative or otherwise, and the ease with which the instrument may be priced, the subject of question 4. If a security trades in a liquid market, there is a strong likelihood

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[53]*See* Merrill Lynch Money Markets Inc. (pub. avail. Jan. 14, 1994) (commercial paper issued in reliance on registration exemption in section 4(2) of Securities Act of 1933); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Investment Company Registrants (Jan. 17, 1992) (government-issued interest-only and principal-only securities backed by fixed-rate mortgages, municipal lease obligations); Letter from Carolyn B. Lewis, Assistant Director, Division of Investment Management, to Catherine L. Heron, Investment Company Institute (June 21, 1991) (municipal lease obligations) [hereinafter ICI letter]; Resale of Restricted Securities; Changes to Method of Determining Holding Period of Restricted Securities under Rules 144 and 145, Investment Company Act Release No. 17452 (Apr. 23, 1990), 55 FR 17933, 17940-41 (Rule 144A securities, foreign securities) [hereinafter Release 17452].

[54]*See* Release 17452, *supra* note 53, at 55 FR 17940-41; ICI Letter, *supra* note 53, at 1.

[55]Release 17452, *supra* note 53, at 55 FR 17940 n.61.

[56]*See, e.g.*, Saul Hansell, *Markets in Turmoil: Investors Undone: How $600 Million Evaporated -- A special report; Fund Manager Caught Short By Crude and Brutal Market*, N.Y. TIMES, Apr. 5, 1994, at A1 [hereinafter *Markets in Turmoil*].

[57]Release 17452, *supra* note 53, at 55 FR 17940 n.61.

that reliable market prices will be readily available. Conversely, reliable prices for securities traded in an illiquid market are often difficult to obtain.

b. Has the Commission considered whether the 15% figure itself should be revisited?

In 1992, the Commission raised the limit on illiquid assets from 10% to 15% for non-money market funds to facilitate capital raising by small businesses.[58] The limit for money market funds remains 10%. Recent illiquidity in the market for certain mortgage derivatives raises once again the question of what limit is appropriate.[59]

The Division has been focusing on the illiquid assets limit in its inspections of mutual funds to determine whether funds are complying with the limit on an ongoing basis, whether funds are holding illiquid investments to the maximum amount permitted, and whether there is a need to reduce the limit. We recommend that the Commission act promptly to consider reducing the ceiling.

6. Does the Use of Derivatives Permit Mutual Funds to Avoid Limitations on the Use of Leverage Mandated by the Investment Company Act of 1940?

a. Please describe for the Subcommittee the original purpose of the restrictions on leverage contained in the Investment Company Act.

Investment company abuse of leverage was a primary concern that led to enactment of the Investment Company Act.[60] In the Act's preamble, Congress cited excessive leverage as a major abuse that it meant to correct, declaring that the public interest and the interest of investors are adversely affected "when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities."[61]

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[58]Release 18612, *supra* note 50.

[59]*See, e.g.*, *Baird Fund*, *supra* note 46; Robert McGough & Anita Raghavan, *PaineWebber Again Props Up Bond Fund*, WALL ST. J., July 25, 1994, at C1 [hereinafter *PaineWebber Again Props Up Bond Fund*].

[60]In 1939, the Commission released an exhaustive study of the investment company industry that laid the foundation for the Investment Company Act. SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 707, 75th Cong., 3d Sess. pt. 1 (1939) [hereinafter INVESTMENT TRUST STUDY PT. 1]; SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 70, 76th Cong., 1st Sess. pt. 2 (1939); SEC, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 279, 76th Cong., 1st Sess. pt. 3 (1939) [hereinafter INVESTMENT TRUST STUDY PT. 3]. For a discussion of leveraged capital structures of investment companies, see INVESTMENT TRUST STUDY PT. 3, Ch. V, "Problems in Connection with Capital Structure," 1563-1940.

[61]Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7). The preamble also refers to "investment companies operat[ing] without adequate assets or reserves." Investment Company Act § 1(b)(8), 15 U.S.C. § 80a-1(b)(8).

Section 18(f) of the Investment Company Act restricts leveraged capital structures, generally prohibiting mutual funds from issuing any class of "senior security."[62] Funds may, however, borrow from banks if they maintain 300% asset coverage for all such borrowings.[63] Section 12(a) authorizes the Commission to regulate two trading practices that may result in leverage, margin purchases and short sales.[64]

One reason for limiting investment company leverage was to prevent abuse of the purchasers of senior securities, which were sold to the public as low risk investments.[65] Investment company assets during the 1920s and 1930s consisted mostly of common stocks that did not provide the stable asset values or steady income stream necessary to support senior charges.[66] Because the sponsors often kept all or most of the junior, voting securities for themselves, they could operate the company in their own interests.[67] Senior securities tended to lead to speculative investment policies to the detriment of senior securityholders because the common stockholder/sponsors, who often had a relatively small investment at risk in the fund, looked to capital gains for profit.[68] Multiple classes of senior securities and

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[62]15 U.S.C. § 80(a)-18(f). "Senior security" is defined to include preferred stock, bonds, debentures, notes, and other securities evidencing indebtedness. Investment Company Act § 18(g), 15 U.S.C. § 80a-18(g).

[63]Investment Company Act § 18(f)(1), 15 U.S.C. § 80a-18(f)(1).

[64]15 U.S.C. § 80a-12(a)(1), (3). The Commission has not adopted any rules under section 12(a); instead it has regulated margin purchases and short sales under section 18. *E.g.*, Guidelines for the Preparation of Form N-8B-1, Investment Company Act Release No. 7221 (June 9, 1972), 37 FR 12790 [hereinafter 1972 Guidelines].

[65]*Id.* at 1583; *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. 265, 272 (1940) (statements of David Schenker, Chief Counsel, and L. M. C. Smith, Associate Counsel, SEC Investment Trust Study) [hereinafter *Senate Hearings*].

[66]*Senate Hearings*, *supra* note 65, at 265; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1587-89.

[67]*Senate Hearings*, *supra* note 65, at 239-40, 268-71, 273; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1594-98. *See* Investment Company Act § 1(b)(3), 15 U.S.C. § 80a-1(b)(3) (public interest and interest of investors adversely affected "when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities").

[68]*Senate Hearings*, *supra* note 65, at 239-40; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1615, 1668-74.

The relatively small investment of the common stockholders meant that the equity "cushion" protecting senior securityholders was small. INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1665-68. Senior securityholders of a mutual fund could be further compromised because the right of redemption held by the fund's common stockholders could erode the "cushion" of equity protecting the senior securityholders. *Investment Trusts and Investment Companies: Hearings on H. R. 10065 Before a Subcomm. of the House Committee on Interstate and Foreign Commerce*, 76th Cong., 3d Sess 121 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Study); INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1870-71. At the time of the study, however,
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pyramiding frustrated senior securityholders' attempts to determine whether secure returns were likely.[69]

Another reason for limiting investment company leverage was to protect public common stockholders by limiting the volatility of their investments. This purpose was a motivating factor for restricting the issuance of senior securities to the public because the leverage of the senior-junior capital structure magnified losses suffered by common stockholders.[70] This purpose also motivated the Investment Company Act restrictions on mutual fund bank borrowings.[71] The provisions authorizing the Commission to regulate margin purchases and short sales implicate similar concerns.

b. Is the leverage that is made available to funds through the use of derivatives inconsistent with the intent underlying the Investment Company Act?

i. Derivatives and leverage

Certain derivatives involve leverage for a fund because they create an obligation, or indebtedness, to someone other than the fund's shareholders and enable the fund to participate in gains and losses on an amount that exceeds its initial investment (referred to herein as "indebtedness leverage"). Examples are futures, forward contracts, and written options. The writer of a stock put option, for example, makes no initial investment, but instead receives a premium in an amount equal to a fraction of the price of the underlying stock. In return, the writer is obligated to purchase the underlying stock at a fixed price, thereby participating in losses on the full stock price.[72] As another example, a fund purchasing a futures contract makes an initial margin payment that is typically a small

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[68](...continued)
mutual funds almost invariably had only one class of securities outstanding. INVESTMENT TRUST STUDY PT. 1, *supra* note 60, at 29; INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1563.

[69]INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1665, 1674-75. Section 12(d)(1) of the Investment Company Act controls pyramiding by restricting an investment company's acquisition of securities issued by other investment companies. 15 U.S.C. § 80a-12(d)(1).

[70]Investment Company Act § 1(b)(7), 15 U.S.C. § 80a-1(b)(7); *Senate Hearings*, *supra* note 65, at 1027-31 (Commission memorandum to the effect that dangers to common stock at least as important as senior securities with respect to ends sought by section 18).

[71]*See Senate Hearings*, *supra* note 65, at 288 (statement of John H. Hollands, Attorney, SEC staff) ("[B]ank borrowings will be a fixed charge against the company; and, because of the fixed charge, the value of the common stock will shoot up and down in the same way that it would if they had debentures outstanding.").

[72]THE OPTIONS CLEARING CORPORATION, CHARACTERISTICS AND RISKS OF STANDARDIZED OPTIONS 17-18 (1985) [hereinafter OCC GUIDE].

percentage of the contract price.[73] As a result of this margin payment, the fund participates in gains and losses on the full contract price.[74]

Other derivatives provide the economic equivalent of leverage because they display heightened price sensitivity to market fluctuations (referred to herein as "economic leverage"), such as changes in stock prices or interest rates. In essence, these derivatives magnify a fund's gain or loss from an investment in much the same way that incurring indebtedness does.[75] One example is a purchased stock call option. In return for the payment of a premium in an amount equal to a fraction of the stock price, the holder of a stock call option participates in gains on the full stock price. If there are no gains, the holder generally loses the entire initial premium.[76] Another example is a leveraged inverse floating rate bond, with an interest rate that moves inversely to a benchmark rate. A leveraged inverse floating rate bond displays heightened price sensitivity to interest rate changes, resulting in the holder experiencing market value fluctuations equivalent to those that he or she would experience on a conventional bond of larger principal amount.[77]

ii. Derivatives and Investment Company Act leverage restrictions

The leverage of derivatives raises concerns related to the volatility of fund common stock, but does not raise concerns related to the protection of public senior securityholders. In the case of derivatives that create indebtedness leverage, the fund assumes a future obligation or indebtedness. While this obligation or indebtedness does not run to public senior securityholders, it does expose the fund to gains and losses on an amount that exceeds its initial investment. In the case of derivatives that create economic leverage, the fund does not assume a future obligation or indebtedness. Investing in these derivatives, however, magnifies the fund's gains or losses in much the same way that incurring indebtedness does.

The Commission and the Division have applied section 18 of the Investment Company Act to derivatives that create indebtedness leverage, such as futures, forward contracts, and written options.[78] In applying section 18 to these instruments, the Commission and the Division have required funds to "cover" the obligations these derivatives create by establishing and maintaining segregated accounts consisting of cash, U.S. government securities, or high-grade debt securities in an amount at least equal in

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[73] ROBERT E. FINK AND ROBERT B. FEDUNIAK, FUTURES TRADING: CONCEPTS AND STRATEGIES 137 (1988).

[74] *Id.* at 39.

[75] *See, e.g.*, Lee Berton, *Understanding the Complex World of Derivatives*, WALL ST. J., June 14, 1994, at C1.

[76] OCC GUIDE, *supra* note 72, at 15-17.

[77] James E. Lebherz, *'Inverse Floaters' Offer Potential Benefits, and Dangers*, WASH. POST, Aug. 29, 1993, at H7.

[78] *E.g.*, Sanford C. Bernstein Fund, Inc. (pub. avail. June 25, 1990); Dreyfus Strategic Investing (pub. avail. June 22, 1987) [hereinafter Dreyfus]; Putnam Option Income Trust II (pub. avail. Sept. 23, 1985); Securities Trading Practices of Registered Investment Companies: General Statement of Policy, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 FR 25128 [hereinafter Release 10666]; 1972 Guidelines, *supra* note 64

value to the obligations.[79] The Division also has permitted funds to cover certain derivatives by holding the underlying instruments or other offsetting instruments.[80] The Commission and the Division have not applied section 18 of the Investment Company Act to derivatives that create economic leverage, such as purchased stock call options and leveraged inverse floating rate bonds.

c. **Apart from its relation to existing provisions in the statute, is the Commission concerned about the leverage available to funds that hold derivatives? If so, how does the Commission propose to address those concerns?**

The Division is concerned about both indebtedness and economic leverage that are potentially made available to funds through the use of certain derivatives. The potential for increased volatility from such leverage may result in significant losses to investors.

One approach to the issue of leverage would be to prohibit directly, or restrict, the use of derivatives by mutual funds. The Commission has imposed requirements on derivative investments by money market funds,[81] but we do not recommend this approach for non-money market funds for three reasons. First, a prohibition or restriction on derivatives use could chill the use of instruments in a manner that is beneficial for mutual funds, such as hedging. Second, a prohibition or restriction on derivatives use would be inconsistent with the general approach of the Investment Company Act, which imposes few substantive limits on mutual fund investments.[82] Funds generally are permitted to make investments without regard to their volatility, *e.g.*, emerging market securities and small company stocks, and we are not persuaded that derivatives should be treated differently.[83] Third, it would be extremely difficult, if not impossible, to devise appropriate prohibitions or

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[79]Release 10666, *supra* note 78, at 44 FR 25131-32. The rationale is that covered transactions do not raise concerns about undue leverage and speculation that section 18 was intended to address. *Id.*

[80]For example, instead of maintaining a segregated account, a fund that sells a call option may cover the position by owning the securities against which the call is written (or securities convertible into the underlying securities without additional consideration) or by purchasing a call on the same securities at the same price. 1972 Guidelines, *supra* note 64. For additional examples of cover, see Dreyfus, *supra* note 78.

[81]These requirements are discussed in response to question 8, below.

[82]The provisions of the Investment Company Act that prohibit or restrict certain types of investment are quite narrow. *See, e.g.*, § 12(d), 15 U.S.C. § 80a-12(d) (investments in other investment companies, insurance companies, or securities-related businesses). *See also* Investment Company Act rule 2a-7, 17 C.F.R. § 270.2a-7 (limiting portfolio investments of money market funds). The framers of the Investment Company Act specifically disavowed any attempt to prohibit speculative mutual fund investments. *See, e.g.*, *Senate Hearings*, *supra* note 65, at 44, 247.

[83]The legislative history of the Investment Company Act indicates that the Act was not intended to eliminate all leverage from fund investments. *See, e.g.*, INVESTMENT TRUST STUDY PT. 3, *supra* note 60, at 1580-81 (common stocks held by investment companies are leveraged in that issuing companies have senior securities in their capitalization); *Id.* at 1592-93 (leverage easier to increase or decrease in investment company with only one class of securities outstanding, where leverage attributable to portfolio securities).

restrictions on the use of derivatives by mutual funds because of the wide variety of instruments that may be considered "derivatives." The available "derivatives" are likely to change as innovation occurs in the marketplace, possibly rendering substantive prohibitions or restrictions ineffective within a short time.

The Division believes that one of the most effective means for addressing leverage concerns associated with mutual fund use of derivatives is improved risk disclosure. It is crucial that investors understand the risks of investing in a mutual fund, including the risks of the fund's intended use of various derivatives. The risk/return profile of a mutual fund may be affected significantly by derivatives that are potentially volatile, and we believe that it is critical that fund investors understand this profile. For this reason, we have given heightened scrutiny to derivatives disclosure in prospectuses, and a Division task force has examined the derivatives disclosures of 100 investment companies. The Division has encouraged registrants to modify their existing disclosure to enhance investor understanding of pertinent risks. We are engaged in fundamental reconsideration of mutual fund disclosure, assessing whether the use of quantitative risk measures would improve investor understanding of fund risk. Because fund use of derivatives is relatively new and evolving, the Division is continuing to develop approaches to improving disclosure about derivatives. If these approaches do not prove to be sufficiently protective of the interests of fund shareholders, the Division may reconsider whether to recommend that the Investment Company Act be amended to place substantive limits on derivatives use.

The Division also recommends that the Commission reexamine the application of section 18 to derivative instruments. In practice, section 18 has proven to be a somewhat crude tool for addressing the leverage issues raised by derivatives, largely because it was originally designed to address a different problem, namely, the leverage created by the issuance of public senior securities.[84] Given the recent proliferation of derivatives, we believe that it is appropriate to reexamine both the way in which section 18 has been applied to derivatives that create indebtedness leverage and the differential treatment under section 18 of derivatives that create indebtedness and economic leverage. These are complicated issues that are not susceptible to a simple solution. For this reason, we recommend that the Commission issue a release seeking public comment on appropriate regulatory and legislative solutions to address the issues raised by leverage resulting from fund use of derivatives.

7. Do the Recent Capital Infusions by Two Fund Complexes Indicate that Bank Mutual Fund Investors may be Facing Special Undisclosed Risks?

The questions raised by the Letter in the area of bank-advised mutual funds relate primarily to the interpretation and application of federal banking laws. The Division's responses are based on our understanding of the banking laws and informal discussions with the staffs of the federal banking agencies. It also may be advisable for Congressmen Markey and Fields to contact the federal banking agencies directly, however, as they have the greatest expertise in interpreting the federal banking laws and are in the best position to predict how they might exercise their authority in specific circumstances.

We emphasize, as a preliminary matter, that a mutual fund's adviser, regardless of whether it is a bank (or a subsidiary or affiliate of a bank), is not legally obligated to infuse

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[84]Bank debt was generally the only significant form of short-term or current indebtedness incurred by the investment companies that the Commission studied prior to passage of the Investment Company Act. INVESTMENT TRUST STUDY PT. 1, *supra* note 60, at 28 n.23.

capital into or purchase depreciated instruments from a fund, absent a violation of law. Mutual funds invest in securities that carry market risk, and fund advisers are not required to guarantee or insure fund performance.

a. **Assume a bank was the adviser for a short-term government bond fund or money market fund that had suffered sharp unexpected losses. If the fund is not part of a separately capitalized subsidiary or affiliate, is there a risk that bank regulatory concerns might prevent the adviser from making a capital infusion into the fund, even if such an infusion was in the interest of the fund's shareholders?**

If a bank was the adviser for a fund that suffered a sharp unexpected loss, bank regulatory concerns could prevent the adviser from making a capital infusion into the fund, even if such an infusion was in the interest of the fund's shareholders. This risk is present whether the adviser is part of the bank itself or is a separately capitalized subsidiary or affiliate.[85]

We understand from our discussions with federal bank regulators that they view the decision to infuse capital into a fund as initially being a business decision of the bank adviser.[86] If, however, in the bank regulators' view, an adviser's capital infusion into a fund threatened the safety and soundness of the bank,[87] it is possible that the bank regulators would take steps to prevent the infusion, regardless of whether it was in the interest of fund shareholders.[88]

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[85]*Cf. Proposed Mellon-Dreyfus Merger: Hearings Before the Subcomm. on Oversight, and Investigations of the House Comm. on Energy and Commerce*, 103d Cong., 2d Sess. 292 (1994) [hereinafter *Mellon-Dreyfus Hearings*] (statement of Eugene A. Ludwig, Comptroller of the Currency) (risk of loss to bank exists whether activities conducted in subsidiary or division of bank).

[86]The questions in the Letter, and our discussion, specifically address the situation where the adviser infuses capital into or purchases instruments from a fund. It is possible, however, that an entity other than the adviser (*e.g.*, the adviser's parent or an affiliate) may assist the fund. Regardless of which entity makes the infusion or purchase, federal bank regulators could object to the infusion or the purchase by any bank affiliate if they believed that it constituted an unsafe or unsound banking practice.

[87]Federal banking laws focus on the safety and soundness of individual banks and the banking system as a whole. *See, e.g.*, Federal Deposit Insurance Act § 8, 12 U.S.C. § 1818 (authorizing federal bank regulators to bring enforcement actions against insured banks that engage in unsafe and unsound banking practices). *See also* MICHIE ON BANKS AND BANKING ch. 15, § 6 (1989 & Supp. 1994).

[88]Recently, however, the Federal Reserve Board did not object when a banking institution assisted a proprietary mutual fund that had sustained losses from derivatives. *See* Snigdha Prakash, *B of A's Bailout of Fund Raises No Red Flags at Fed*, AM. BANKER, July 7, 1994, at 12 (public statement by Federal Reserve Board Governor that bank's capital infusion was an "unusual circumstance" and did not raise concerns about the safety and soundness of the banking system)[hereinafter *B of A Article*]. Other banking institutions recently have taken similar actions, apparently without intervention by the bank regulators *See, e.g.*, *Stepping up to the Plate*, *supra* note 6.

Even if an adviser was organized as a subsidiary of the bank, bank regulators still could cite bank safety and soundness as grounds for objecting to a capital infusion. The Office of the Comptroller of the Currency, for example, has traditionally viewed national bank operating subsidiaries as departments of the parent bank.[89] Thus, operating subsidiaries of national banks are subject to the same banking laws and regulations as the parent bank and to examination and supervision by the Office of the Comptroller of the Currency.[90] Consistent with this principle, the Comptroller of the Currency has indicated that, even if a fund adviser is a separately capitalized bank subsidiary, he still would have concerns about the adviser's activities and potential risks to bank capital.[91]

If advisory activities were conducted in a separately capitalized affiliate of a bank other than a bank subsidiary (*e.g.*, a holding company subsidiary or the holding company itself), there would be a clearer financial separation between the bank and the adviser than if the adviser was a bank subsidiary.[92] Because it is less likely that an affiliate adviser's activities would threaten the safety and soundness of the bank, it also may be less likely that bank regulators would object to the affiliate adviser infusing capital into a fund.[93]

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[89]*See* former OCC Interpretive Ruling 7.7376, 12 C.F.R. § 7.7376 (1983), *rescinded* 48 FR 48452 (1983); 12 C.F.R. § 5.34. Operating subsidiaries only can perform activities that the parent bank can perform. 12 C.F.R. § 5.34(c).

[90]12 C.F.R. §§ 5.34(d)(2)(i), 5.34(d)(3). *See also Mellon-Dreyfus Hearings*, *supra* note 85, at 284 (statement of Eugene A. Ludwig, Comptroller of the Currency).

[91]*Mellon-Dreyfus Hearings*, *supra* note 85, at 292. (statement of Eugene A. Ludwig, Comptroller of the Currency) ("[f]rom the perspective of bank safety and soundness, the most serious concern raised by a proposal such as Mellon's is the possibility of [bank] exposure to operational or fiduciary losses in its mutual fund subsidiary.") Specifically, Comptroller Ludwig expressed concern that "bank managers might feel strong pressure to reimburse an affiliated mutual fund or its customers for market losses, particularly if a money-market mutual fund managed by the bank would otherwise fail to maintain a constant net asset value" or "to provide emergency credit to or investments in a mutual fund subsidiary to cover an unexpected surge in redemptions." *Id.*

[92]This would be the case because an affiliate's capital is not tied to the bank's capital as directly as a subsidiary's. *Cf. Restructuring of the Banking Industry: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 102d Cong., 1st Sess. Part II, 240 (1991) (statement of Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission, regarding bank conduct of broker-dealer activities).

[93]It should be noted, however, that banking law requires the Federal Reserve to assure the safety and soundness of bank holding companies and nonbank bank holding company subsidiaries. *See* 12 U.S.C. § 1818(b)(3).

b. Would the adviser be able to repurchase instruments from the fund that were believed to be the source of the losses?

In addition to the safety and soundness concerns discussed above, whether a bank adviser would be able to purchase instruments from a fund would depend on the types of instruments to be purchased and how they are treated under banking law.[94] For example, the Glass-Steagall Act generally prohibits a national bank from purchasing and selling securities for its own account.[95] The Act, however, excepts from this prohibition certain government obligations and "investment securities."[96]

Whether a derivative will be viewed as a security for purposes of the Glass-Steagall Act will depend on the particular type of instrument and its use. Federal bank regulators generally do not view futures contracts and related options, foreign currency contracts, swaps, and other commodities-related investments as securities under the Glass-Steagall Act.[97] Options (other than options on futures contracts), on the other hand, may be treated as securities under that Act.[98]

Even if a derivative is not viewed as a security subject to the restrictions of the Glass-Steagall Act, a bank still may not be free to purchase the derivative from a fund. The purchase also must conform with recently adopted bank regulatory guidelines on derivatives activities, which generally set forth managerial, operational, and internal control requirements for bank derivatives activities.[99]

In addition, whether a bank adviser would be able to purchase instruments from a fund depends on whether the purchase is restricted by Sections 23A and 23B of the Federal Reserve Act. These provisions restrict transactions (including the purchase and sale of securities or other assets) between banks and their affiliates by imposing aggregate

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[94]Section 17(a) of the Investment Company Act also restricts an investment adviser's ability to purchase instruments from a fund. 15 U.S.C. § 80a-17(a). *See* PaineWebber Managed Investments Trust (pub. avail. Aug. 4, 1994). See the discussion in section 8.b., below.

[95]Glass-Steagall Act, § 16, 12 U.S.C. § 24 (Seventh).

[96]Glass-Steagall Act, § 16, 12 U.S.C. § 24 (Seventh). The Glass-Steagall Act authorizes the Comptroller of the Currency to interpret the definition of investment securities. *Id.* The Comptroller of the Currency has used this authority to adopt regulations defining the term "investment securities" and limiting the purchase of such securities by national banks. *See* 12 C.F.R. Part 1.

[97]MELANIE L. FEIN, SECURITIES ACTIVITIES OF BANKS § 13.01 (1991).

[98]*Id.*

[99]*See, e.g.*, Banking Circular No. 277 (Oct. 27, 1993) (risk management guidelines issued by the Comptroller of the Currency). The Office of the Comptroller of the Currency also recently proposed amending its risk-based capital guidelines to increase capital requirements for national banks that deal in certain derivatives. Capital Adequacy: Calculation of Credit Equivalent Amounts of Off-Balance Sheet Contracts, Docket No. 94-13 (Aug. 24, 1994), 59 FR 45243. *See also* Jay Matthews, *Rules for Banks' Use of Derivatives Issued*, WASH. POST, Sept. 2, 1994, at B2.

transaction limits, collateralization requirements, and arm's length dealing requirements.[100] Section 23A generally prohibits a bank and its subsidiaries from purchasing a low-quality asset from an affiliate.[101] For purposes of Sections 23A and 23B, the term "affiliate" includes any investment company advised by the bank or any affiliate of the bank.[102]

c. **Would you agree that the failure to permit such an injection or repurchase could result in a further downward spiral for the fund, leading to even greater losses for investors?**

If an adviser elects not to infuse capital into, or purchase a depreciated instrument from, a fund to compensate investors for their losses (or is prohibited from doing so), it is possible that dissatisfied investors may redeem their shares, causing the fund to sell portfolio securities to meet redemption requests.[103] These sales could (depending on the market), in turn, lead to greater losses for the fund, in effect causing a "downward spiral." Moreover, if the depreciated instrument is illiquid, the fund likely would choose to sell other, more liquid portfolio instruments to meet the redemption requests. Such sales would increase the percentage of fund assets held in the depreciated instrument, thereby increasing the fund's sensitivity to price fluctuations in that instrument and exposing investors to greater losses if the price of the instrument continues to decline. These losses could occur in any fund, whether or not advised by a bank, and no adviser is required to compensate fund shareholders for losses absent a violation of law.

d. **Should the prospect that such infusions or repurchases might not be permitted be disclosed to bank mutual fund investors?**

The Commission has broad authority under the Securities Act of 1933 and the Investment Company Act to require a fund prospectus to include any material information necessary to make the statements contained in the prospectus not misleading.[104] When the Commission or the Division has determined that there is a unique material risk associated with a particular type of fund, it has required particular disclosure in the prospectus of those funds. For example, the Division requires every bank-sold mutual fund and every mutual fund whose name is similar to a bank's name to disclose prominently on the cover page of

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[100]12 U.S.C. §§ 371c and 371c-1.

[101]12 U.S.C. § 371c(a)(3).

[102]12 U.S.C. § 371c(b)(1)(D)(ii).

[103]The immediate effect of a capital infusion into, or a purchase of a depreciated instrument from, a fund is to increase the cash position of the fund, thereby increasing liquidity and enabling the fund to meet redemptions without having to sell portfolio securities.

[104]*See, e.g.*, Securities Act of 1933 §§ 6, 7, 8, 10, 19(a), 15 U.S.C. §§ 77f, 77g, 77h, 77j and 77s(a); Securities Act rule 408, 17 C.F.R. § 230.408; Investment Company Act §§ 8, 30(a), 38(a), 15 U.S.C. §§ 80a-8, -30(a), -38(a); Investment Company Act rule 8b-20, 17 C.F.R. § 270.8b-20.

its prospectus that the shares in the fund are not federally insured.[105] Similarly, the Commission also requires every money market fund to disclose, on the cover page of its prospectus and in its advertising, both that its shares are not insured or guaranteed by the U.S. government and that there is no assurance that the fund will be able to maintain a stable net asset value of $1.00.[106]

Bank regulators have not yet objected generally or, to our knowledge, specifically to bank advisers infusing capital into or purchasing depreciated instruments from their funds. In fact, one regulator reportedly has stated specifically that a capital infusion by one banking institution did not raise concerns.[107] In addition, a mutual fund's adviser, regardless of whether it is a bank, is not legally obligated to infuse capital or purchase depreciated instruments from the fund, absent a violation of law. Accordingly, it does not seem warranted at this time for the Commission or the Division to mandate disclosure for all bank-advised funds concerning the potential limits on a bank adviser's ability to assist its fund. Rather, we believe that each bank-advised fund individually should assess its own circumstances to determine whether this is a material risk that should be disclosed.

e. Better still, is there a way to avoid the conflict between the bank and the fund?

Under the current regulatory scheme, there is the potential for conflict between a bank's obligations under the banking laws and the interests of the fund and its shareholders with respect to capital infusions and purchases of securities. While it is unlikely, for the reasons discussed above, that requiring a bank to conduct its fund advisory activities in a separately capitalized subsidiary or affiliate would eliminate the conflict completely, it would appear to reduce the potential for conflict between the bank and the fund, particularly if such activities are conducted in a separately capitalized affiliate.

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[105] Letter from Barbara J. Green, Deputy Director, Division of Investment Management, to Investment Company Registrants (May 13, 1993). The Division was concerned that investors may mistakenly believe that these mutual funds are federally insured or similarly protected by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or some other agency. *Id.*

[106] Form N-1A, Item 1(a)(vi), 17 C.F.R. §§ 239.15A and 274.11A (registration statement of open-end management investment companies); Securities Act Rule 482(a)(7), 17 C.F.R. § 230.482(7) (advertising by an investment company). In the release proposing this money market fund disclosure, the Commission stated that "[w]hile money market funds have been one of the safest available investment options, the Commission believes it is important for investors to understand that money market funds are not risk-free." Investment Company Act Release No. 17589, at text accompanying n.68 (July 17, 1990) 55 FR 30239, 30247.

[107] *See B of A Article*, *supra* note 88, at 12 (public statement by Federal Reserve Board Governor that bank's capital infusion was an "unusual circumstance" and did not raise concerns about the safety and soundness of the banking system).

8. **Recent Instability of Money Market Mutual Funds. Please bring us up-to-date on the Commission's latest views about the appropriateness of derivatives for money market portfolios.**

a. Background

Money market funds generally seek to maintain a stable net asset value per share, typically $1.00. Many money market funds allow investors to use checks to redeem shares, and, because the value of an account generally does not change due to share value fluctuations, many investors use money market funds as alternatives to checking accounts since they can readily ascertain their account balances. While these features of money market funds may be responsible for their success, they may also be responsible for the erroneous perceptions of some investors that money market funds are "guaranteed" or for some other reason cannot lose value. To help reduce these misconceptions, the Commission in 1991 amended its rules governing money market fund disclosure to require money market fund prospectuses and sales material to disclose prominently (1) that the shares of the money market fund are neither insured nor guaranteed by the U.S. Government and (2) there is no assurance that the fund will be able to maintain a stable net asset value of $1.00 per share.[108]

Prior to the adoption of 1991 amendments to rule 2a-7 under the Investment Company Act, the Commission's rule governing money market funds, a money market fund was required to comply with the rule only if the fund wished to take advantage of the rule's exemptive provisions that permit many money market funds to use the "amortized cost" method of valuing their portfolio.[109] As a result, some funds that held themselves out as money market funds routinely invested in risky securities that were inconsistent with developing investor expectations of money market funds, such as securities whose principal values or returns were based on non-dollar denominated indexes. To assist investors to better understand money market funds, the Commission in 1991 prohibited mutual funds from calling themselves money market funds unless they comply with the risk-limiting provisions of rule 2a-7.[110]

b. Money Market Funds and Derivatives

Money market funds invest in a variety of instruments that could be characterized as derivatives. Many of these securities are created especially for money market fund portfolios, have a very low level of risk, and have performed as expected during the recent series of short-term interest rate increases. There have, however, been an unfortunate

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[108]Revisions to Rules Regulating Money Market Funds, Investment Company Act Release No. 18005 (Feb. 20, 1991), 56 FR 8113 (amendments to Form N-1A, Item 1(a)(ix)).

[109]Money market funds that seek to maintain a stable share price generally use either the amortized cost method of valuation or the penny-rounding method of share pricing. Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. 17 C.F.R. § 270.2a-7(a)(1). Share price is determined under the penny-rounding method by valuing securities at market value, fair value, or amortized cost and rounding the per share net asset value to the nearest cent. 17 C.F.R. § 270.2a-7(a)(11).

[110]17 C.F.R. § 270.2a-7(b). These provisions are designed to limit a fund's exposure to credit, interest rate, and currency risks. 17 C.F.R. § 270.2a-7(c)(2)-(4).

number of recent instances in which money market funds have invested in adjustable rate notes that have experienced significant volatility and losses. Losses in value attributable to these securities have resulted in a number of money market fund advisers electing to take actions, including contributing capital or purchasing instruments held by the funds, to prevent the funds' net asset values from falling below $1.00.[111]

Rule 2a-7 limits a money market fund's exposure to interest rate risk by generally prohibiting it from acquiring securities with remaining maturities that exceed 397 days.[112] The rule permits a money market fund to measure the maturity of a long-term adjustable rate security by reference to its interest rate readjustment date if the fund and its adviser "reasonably expect the value of the security to approximate par upon adjustment of the interest rate."[113]

Last year, the Division became aware that some funds were investing in adjustable rate securities that had interest rate adjustment formulae that would be unlikely to follow short-term interest rates if those interest rates increased.[114] A December 1993 Commission release proposing amendments to rule 2a-7 discussed the risks of money market fund investment in these types of adjustable rate securities.[115] In the release, the Commission noted that these types of securities "share the common characteristic that, at the time of issuance, changes in interest rates or other conditions that can reasonably be foreseen to occur during their term will result in their market values not returning to par at the time of an interest rate readjustment."[116] The Commission concluded that such securities are not appropriate investments for a money market fund.

Several months ago it became apparent that some funds continued to hold these types of securities. Because of an increase in interest rates, the volatility of these instruments increased. In June, you raised this issue in correspondence with the chief executive officers of the 80 largest fund complexes.[117] Later that month, the Division provided money market funds and their advisers with additional guidance concerning investments in adjustable rate securities.[118] The Division reminded fund managers of their general obligations under rule

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[111]*See, e.g.*, *Stepping up to the Plate*, *supra* note 6.

[112]17 C.F.R. § 270.2a-7(c)(2).

[113]17 C.F.R. § 270.2a-7(a)(7), (21).

[114]These securities include capped floaters (whose floating rates will not adjust above a stated level), CMT floaters (whose floating rates are tied to long-term rates and which will not return to par if the relationship between short- and long-term rates changes), leveraged floaters (whose floating rates move at multiples of market interest rate changes), and COFI floaters (whose floating rates are tied to the Cost of Funds Index, representing the cost of funds to thrift institutions in the Eleventh Federal Home Loan Bank District, which substantially lags market rates).

[115]Release 19959, *supra* note 14, at Part II.D.2.d., 58 FR 68601-02.

[116]*Id.* at 58 FR 68601.

[117]Levitt Letters, *supra* note 10.

[118]Letter from Barry P. Barbash, Director, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (June 30, 1994).

2a-7 to ensure that money market funds invest only in those securities that are consistent with maintaining stable net asset values. The Division also urged money market fund advisers to reexamine all portfolio holdings to determine whether the funds hold adjustable rate securities that exhibit the characteristics described above. Funds that hold these securities were directed to work with their advisers in developing plans for their orderly disposition.

To maintain their funds' net asset values at $1.00, a number of fund advisers have purchased certain adjustable rate securities from their money market funds at their amortized cost value (plus accrued interest).[119] Such a transaction is prohibited by section 17(a) of the Investment Company Act unless the Commission issues an order approving the transaction as "reasonable and fair and . . . not involv[ing] overreaching on the part of any person concerned."[120] In each case, the adviser represented that the purchase price of the security exceeded the security's market value and the transaction assisted in maintaining a stable net asset value. Accordingly, the Commission could have been expected to make the finding necessary to issue an order permitting the transaction. Because of the need to consummate the transactions quickly, however, the Division, as it has done in the past in similar instances, granted oral "no-action" relief in which we assured fund advisers and related parties that we would not recommend enforcement action if the transaction was effected.[121]

Adoption of the Commission's proposed rule 2a-7 amendments and the June guidance given by you and the Division should provide additional protection for money market fund investors. No rule text, however, can anticipate events that may result in a fund's net asset value falling below $1.00. To date, a number of sponsors or advisers of money market funds with positions in the types of adjustable rate securities identified in the Commission's December 1993 proposal have taken actions to cause the net asset values of those funds not to fall below $1.00. The Division believes that the potential continues to exist that a sponsor or adviser of a fund holding these or other types of adjustable rate instruments that pose similar risks will be unable or unwilling to take similar actions, and that the net asset value of such a fund will fall below $1.00.

The Division will continue to be vigilant in enforcing compliance with all provisions of rule 2a-7. In addition, we will persist in our efforts to impress upon investors that money market funds are not insured or guaranteed.

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[119] *See, e.g., Stepping up to the Plate, supra* note 6.

[120] Investment Company Act § 17(a)(2), (b), 15 U.S.C. § 80a-17(a)(2), (b).

[121] In each case, the relief was limited to section 17(a). This procedure, and the criteria used by the Division for granting "no-action" relief, are discussed in Release 19959, *supra* note 14, at Part IV. In that Release, the Commission proposed a new rule 17a-9, which would exempt from section 17(a) certain purchases from a money market fund of securities that are no longer eligible money market fund investments. The proposed rule was originally designed to address situations where the security to be purchased was in default. In light of recent events, we are considering whether to recommend that the proposed rule also apply to securities that no longer satisfy the criteria for money market fund investment in adjustable rate instruments.

PERSONAL INVESTMENT ACTIVITIES OF INVESTMENT COMPANY PERSONNEL

Report of the
Division of Investment Management
United States Securities and Exchange Commission

September 1994

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PERSONAL INVESTMENT ACTIVITIES OF INVESTMENT COMPANY PERSONNEL

I. INTRODUCTION AND EXECUTIVE SUMMARY

Over the last 15 years, the investment company industry has been remarkably successful. Between 1979 and 1994, total assets under management grew from $95 billion to $2.1 trillion. Over 38 million Americans now invest in mutual funds, the most popular type of investment company, entrusting their retirement savings, funds for their childrens' education and their ready cash to mutual fund managers. By the end of last year, 27% of U.S. households owned mutual funds.

The success of the investment company industry is in no small measure the result of the industry's excellent record; the industry has generally been free of major scandal for the last two decades. The industry's continued health, however, depends on its meeting the expectation of American investors, many of whom are new to the market. The industry will continue to be trusted by investors only if it demonstrates that it maintains the highest possible ethical standards and that it operates free from abusive and fraudulent practices.

Recent press reports and Congressional inquiries have raised questions about the ethical standards of the industry by focusing on the personal investment activities of investment company personnel. In seeking to address these questions, the Division of Investment Management (the "Division") has, over the past seven months, undertaken a detailed examination of the personal investment activities of investment company personnel, particularly fund managers, and conducted an analysis of the regulatory scheme that governs those investment activities. In particular, the Division:

- examined the personal securities transactions for 1993 of 622 fund managers employed by 30 companies ("fund groups") that, in the aggregate, manage 1,053 funds with total assets of $521 billion;

- examined the restrictions and procedures placed on the personal investment activities of fund personnel by the 30 fund groups;

- analyzed the provisions of section 17(j) of the Investment Company Act of 1940 (the "1940 Act") and rule 17j-1 under the 1940 Act, the principal federal provisions regulating the investment activities of fund personnel; and

- assessed the recommendations contained in a report by a special advisory group formed by the Investment Company Institute (the "ICI") that surveyed the industry's practices and standards governing personal investing by fund personnel.

This Report describes the Division's findings and contains recommendations designed to enhance the oversight of the personal investment activities of fund personnel and improve ethical standards throughout the fund industry. The vast majority of the 30 fund groups from which the Division collected data reported moderate to infrequent investing by their fund managers, little of which was potentially abusive. A small number of fund groups, however, reported extensive personal investment activity by their fund managers, who, in several instances, purchased or sold securities shortly ahead of their funds. The Division currently is obtaining additional information about all potentially abusive transactions.

The data collected from the 30 fund groups revealed that:

- Fund managers generally appear not to invest extensively for their personal accounts. Of the fund managers whose transactions the Division examined, 75% engaged in ten or fewer transactions in 1993 (the year covered by the Division's requests for information), while 43.5% did not buy or sell securities at all. The median number of personal transactions per manager for 1993 was two.

- Potential conflict of interest situations caused by fund managers buying and selling securities ahead of their funds appear to be infrequent. The overwhelming majority of fund managers did not buy or sell securities during the ten days preceding the purchase or sale of those securities by their funds. In 0.7% of all personal transactions reported to the Division a fund manager purchased or sold securities at a better price than received by his fund during the 10 days following the manager's transaction. In addition, in 1.8% of the reported transactions a fund manager received a better price than some fund in the same fund group.

- Potential conflict of interest situations caused by a fund's purchase or sale of securities already held by the fund's manager appear to be infrequent. Less than 3% of all equity securities purchased by the funds examined were, at the time of purchase, also owned by the fund's manager. Many of these securities were issued by large capitalization companies, and therefore provide a minimal potential for conflict.

- The investment activities of a few fund managers were inconsistent with the general trends reflected in the data. Fund managers employed by four fund groups accounted for a large percentage of personal transactions generally and of transactions that mirrored fund transactions within a ten day period. Although these four fund groups collectively employed only 15.5% of the managers whose trades were examined, those managers engaged in nearly half of all personal transactions reviewed, 70% of personal transactions that matched transactions made by the manager's fund, and 50% of personal transactions that matched a transaction made by the manager's fund or any other fund in the same fund group.

- The data collected from the 30 fund groups may overstate the extent of personal investing and the number of potentially abusive transactions in the fund industry generally. The Division intentionally included in its examination three fund groups whose managers, in the past, traded actively for their personal accounts. All three groups were among the four fund groups whose managers engaged in the most personal transactions and the most transactions ahead of their funds. By contrast, most of the fund managers employed by 26 of the 27 fund groups that were selected for examination without regard to the suspected frequency of personal trading by their managers engaged in few personal transactions generally and very few potentially abusive personal transactions.

The Division has concluded that the data collected, taken as a whole, suggests that the existing regulatory framework governing the personal investment activities of fund personnel has generally worked well, but can be improved. The data, in any event, does not reveal abusive trading patterns that the Division believes could be remedied only by a total prohibition on personal investing by fund personnel.

To improve the regulatory scheme, the Division is making six recommendations. The Division's recommendations are designed to further protect fund shareholders by making available to the public additional information about fund policies on personal investment; enhancing the oversight of personal investment policies by fund boards of directors or trustees; making it easier for both funds and the Commission's staff to monitor the personal transactions of fund personnel; and clarifying the scope of prohibited activities by fund personnel. The Division believes that its recommendations, together with the industry's general acceptance of the principles reflected in the report of the ICI's special advisory group, would enhance ethical standards throughout the fund industry which, in turn, should bolster investor confidence. The Division's recommendations are as follows:

- The Commission should require every fund to publicly disclose its policies regarding personal investing by fund personnel;

- The Commission should require each fund's board of directors or trustees to review the fund's code of ethics and compliance matters relating to the code at least annually;

- The Commission should require fund personnel to disclose to their employers their personal securities holdings at the commencement of employment;

- The National Association of Securities Dealers, Inc. (the "NASD") should be asked to consider adopting a rule requiring its member broker-dealers to notify a fund's investment adviser when one of the adviser's employees opens a brokerage account and, upon request, to transmit duplicate trade confirmations and account statements to the adviser;

- The NASD should be asked to consider prohibiting the participation by certain fund personnel in "hot issue" public offerings; and

- Section 17(j) of the 1940 Act should be amended to include purchases and sales of property other than securities, and to clarify the section's scope.

The Division's recommendations are discussed more fully in Part V of this Report.

II. BACKGROUND

A. Regulation of Personal Investing

Investment advisers owe their customers the highest duty of trust and fair dealing and must place the customers' interests ahead of their own.[1] Thus, although federal law does not specifically prohibit a fund manager from buying or selling the same securities as the

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[1] *SEC v. Capital Gains Bureau, Inc.*, 375 U.S. 180 (1963).

funds with which he[2] is associated, he may not, when making investment decisions for himself or the funds, place his personal interests ahead of the funds' interests.[3]

In performing their day-to-day responsibilities, fund personnel, such as managers, analysts, and traders, may have access to information about impending fund transactions. Under current law, these "access persons," like other "insiders," may not use material nonpublic information to benefit themselves or others. Access persons of a fund may not, for example, engage in "front-running," which occurs when an access person engages in a securities transaction ahead of a fund with the expectation that the fund's transaction will favorably affect the price of the securities. Front-running is most likely to benefit an unscrupulous access person when it involves a security that is thinly traded.

Conflicts of interest can arise whenever access persons buy and sell securities for their personal accounts. Beginning in the early 1960s, Congress and the Commission attempted to devise a regulatory scheme that would effectively address these potential conflicts. Their efforts culminated in the addition of section 17(j) to the 1940 Act in 1970 and the adoption of rule 17j-1 under the Act by the Commission in 1980.

Three themes run through the extensive legislative and administrative history of section 17(j) and rule 17j-1. First, both Congress and the Commission consistently have recognized that effective regulation of the investment activities of access persons requires that funds themselves provide a strong first line of oversight. Second, both Congress and the Commission have indicated that funds can best provide effective oversight if they are given the flexibility to adopt restrictions on personal investment activities, and procedures implementing those restrictions, that are tailored to the funds' individual circumstances; indeed, the Commission on occasion has rejected staff recommendations to formulate uniform standards that would apply to all funds. Third, Congress and the Commission consistently have recognized that not all personal securities transactions by access persons involve conflicts of interest or are inconsistent with the responsibilities of access persons toward their funds. As a result, both Congress and the Commission have to date declined to impose an outright ban on personal investment by fund personnel.

1. <u>Section 17(j)</u>

In 1961, Congress directed the Commission to undertake a study of the securities markets, which resulted in the issuance in 1963 of a Commission staff report known as the Special Study Report.[4] Although the Special Study Report was concerned primarily with the securities markets in general, the Report addressed certain investment company issues, including "insider transactions in portfolio securities." As part of its analysis, the staff examined the nature and extent of trading by a representative sample of mutual funds and

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[2] For ease of reading we have used the masculine form throughout this Report in referring to fund personnel.

[3] *Capital Gains*, *supra* note 1.

[4] Report of the Special Study of the Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

their insiders,[5] and concluded that personal trading by insiders ahead of their funds was "fairly extensive" and "significant."[6] Despite these findings, the staff did not recommend a ban on personal investment by fund insiders, but concluded that "each mutual fund, its investment adviser, and principal underwriter should be required to adopt written policies covering insider trading and provisions for their implementation which meet minimum standards established by the Commission."[7]

In 1966, the Commission published a report dealing with the public policy implications of investment company growth (the "PPI Report") that analyzed the need to update the regulation of mutual funds in light of the fund industry's significant growth since the passage of the 1940 Act.[8] The PPI Report dealt with, among other things, the issue of personal investing by fund personnel and identified three areas of particular concern. First, a fund's insiders can profit by buying or selling securities ahead of the fund's transactions in the same securities if the fund's transactions affect the price of the securities. Second, a fund can be harmed if an insider's securities transactions adversely affect the transaction prices received by the fund. Third, a fund can be harmed if an insider causes the fund to purchase or hold securities to protect or strengthen the insider's investment in those securities.[9]

The Commission, in the PPI Report, noted that the Special Study Report had found "widespread" buying and selling by fund insiders before their funds.[10] Nevertheless, the Commission did not recommend a ban on investing by fund insiders, concluding that "persons affiliated with investment companies cannot be expected to refrain from engaging in securities transactions for their personal accounts."[11]

The Commission acknowledged in the PPI Report that it had authority under the broad antifraud provisions of the Securities Exchange Act of 1934 (the "Exchange Act") and the Investment Advisers Act of 1940 (the "Advisers Act") to adopt rules against insider trading abuses by persons affiliated with investment companies.[12] The Commission noted, for instance, that those provisions would have allowed it to establish uniform minimum standards governing personal investing by fund insiders. The Commission, however, stated

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[5] The Special Study Report looked initially at 51 funds with total net assets of $14.9 billion, then looked more closely at 28 funds with total net assets of $5.2 billion. For this Report, the Division collected data with respect to 1,053 funds with net assets of $521 billion.

[6] Special Study Report, *supra* note 4, at 254, 255.

[7] *Id.* at 254. The staff further recommended that "[t]he standards which are called for should be common to the entire industry, and their adoption and implementation should not be left to the individual companies themselves." *Id.* The Commission consistently has declined to follow this particular recommendation.

[8] Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966).

[9] *Id.* at 195.

[10] *Id.* at 196 (citing the Special Study Report).

[11] PPI Report, *supra* note 8, at 199.

[12] *Id.* at 200.

its preference "to deal with problems of insider trading in investment company portfolio securities in a more flexible manner," by requiring every fund subject to the 1940 Act to adopt its own code of ethics.[13] Thus, the Commission asked Congress for authority under the 1940 Act to adopt rules for the protection of investors in connection with "insider trading in portfolio securities by persons affiliated with investment companies."[14]

In response to the Commission's request for rulemaking authority in the PPI Report, Congress in 1970 added section 17(j) to the 1940 Act. Section 17(j) makes it unlawful for persons affiliated with a registered investment company or with the company's investment adviser or principal underwriter, in connection with tne purchase or sale of securities held or to be acquired by the company, to engage in any fraudulent, deceptive, or manipulative act or practice in contravention of rules adopted by the Commission. Section 17(j) expressly states that "such rules and regulations may include requirements for the adoption of codes of ethics" by funds and their affiliated persons.

In explaining its decision to provide for Commission rulemaking in section 17(j), Congress noted that:

> The ability to deal with [personal securities] transactions by rule is intended to permit the Commission to draw flexible guidelines to prohibit persons affiliated with investment companies, their advisers and principal underwriters, from engaging in securities transactions for their personal accounts when such transactions are likely to conflict with the investment programs of their companies.[15]

Thus, the express language and legislative history of section 17(j) make clear that Congress was not seeking, and was not authorizing the Commission, to ban all personal investment activity by fund insiders. Section 17(j) contemplates that the insiders of a fund could not only buy and sell securities, but also that they could buy and sell securities held or to be acquired by the fund. The legislative history of section 17(j) suggests a concern on the part of Congress about insider transactions involving conflicts of interest and not about insider transactions generally.

2. <u>Rule 17j-1</u>

In 1972, the Commission first proposed rule 17j-1 under the rulemaking authority provided by section 17(j).[16] The proposed rule differed from the rule now in effect primarily in two ways. First, the proposed rule expressly would have permitted (but did not require) funds to pre-clear personal trades by access persons. Second, it would have prohibited an access person from trading for his personal account any securities that he knew were being purchased or sold, or were being considered or recommended for purchase or sale, by the fund. Commenters heavily criticized the proposed rule, particularly the

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[13] *Id.*

[14] *Id.*

[15] H.R. Rep. No. 1382, 91st Cong., 2d Sess., at 28 (1970) ("House Report"); S. Rep. No. 184, 91st Cong., 1st Sess., at 29 (1969) ("Senate Report").

[16] Investment Company Act Release No. 7581 (Dec. 26, 1972).

personal trading prohibition, which they described as "nebulous," "difficult to apply," "extremely vague and impossible of application in specific situations," and "dangerously ambiguous."[17] In response to the negative comments, the Commission withdrew proposed rule 17j-1 in 1976.[18]

In 1978, the Commission reproposed rule 17j-1 with several significant changes.[19] Among other things, the reproposed rule did not contain any specific trading prohibitions. The Commission explained that this revision was made "in view of the arguments made by public commentators that the trading prohibitions set forth in the previous proposed rule could lead to difficulties of interpretation and administration."[20] Moreover, the Commission declined to include *suggested* personal trading restrictions in the release that accompanied reproposed rule 17j-1.

In 1980, the Commission adopted rule 17j-1.[21] The rule, which has not been amended since its adoption, has four primary components:

- Paragraph (a) prohibits fraudulent, deceptive or manipulative acts by any affiliated person (which includes an investment adviser) or principal underwriter of an investment company, or any affiliated person of the company's investment adviser or principal underwriter, in connection with their personal transactions in securities[22] held or to be acquired by the investment company.

- Paragraph (b) requires investment companies and their investment advisers and principal underwriters to adopt codes of ethics containing provisions reasonably necessary to prevent access persons[23] from engaging in the fraudulent, deceptive, or manipulative acts prohibited by the rule.

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[17] Commenters also criticized nearly every other aspect of the proposed rule, including the types of transactions proposed to be covered by the rule, the rule's application to non-interested directors, the definition of the term "access person," and the proposed requirement that violations of a firm's code of ethics be reported to the Commission.

[18] Investment Company Act Release No. 9169 (Feb. 19, 1976).

[19] Investment Company Act Release No. 10162 (Mar. 20, 1978).

[20] *Id.*

[21] Investment Company Act Release No. 11421 (Oct. 31, 1980).

[22] The definition of "securities" in rule 17j-1 excludes, among other things, United States government securities, commercial paper, and shares of open-end funds. United States government securities are excluded because "the value of such securities held by an individual could not be substantially affected by purchases or sales by an investment company." Release No. 10162, *supra* note 19. Commercial paper and shares of open-end funds are excluded because they "present very little opportunity for the type of improper trading that the Rule is intended to cover." Release No. 11421, *supra* note 21.

[23] As defined in rule 17j-1(e). "access persons" of an entity generally include officers, directors, and any employees who participate in the selection of a fund's portfolio securities or who have access to information regarding a fund's impending purchases and sales of portfolio securities.

▸ Paragraph (c) requires access persons of investment companies and of their investment advisers and principal underwriters to report their personal securities transactions to their employers on a quarterly basis.

▸ Paragraph (d) requires investment companies and their investment advisers and principal underwriters to maintain certain records, including their codes of ethics and the quarterly reports filed by access persons, and to make those records available for inspection by the Commission.

Rule 17j-1 does not mandate any specific restrictions on personal investing by access persons, or any procedures to implement those restrictions. Instead, the rule requires registered investment companies and their investment advisers and principal underwriters[24] to serve as a first line of oversight with respect to the investment activities of access persons by determining for themselves which trading restrictions and procedures are "reasonably necessary" to prevent access persons from engaging in the fraudulent, deceptive, or manipulative acts and practices prohibited by the rule. In explaining its reason for adopting this approach, the Commission said:

> [T]he variety of employment and institutional arrangements utilized by different investment companies renders impracticable a rule designed to cover all conceivable possibilities. Moreover, as a matter of policy the Commission believes the introduction and tailoring of ethical restraints on the behavior of persons associated with an investment company can best be left in the first instance to the directors of the investment company.[25]

3. Other Provisions of the Federal Securities Laws

Abusive personal investment activities by fund access persons are prohibited not only by section 17(j) and rule 17j-1, but also by other provisions of the federal securities laws. A fund manager who engages in front-running or makes investment decisions for the fund with the intent to benefit personally, for example, would, in addition to violating section 17(j) and rule 17j-1, violate the antifraud provisions of section 17(a) of the Securities Act of 1933 (the "Securities Act") and section 10(b) of the Exchange Act and rule 10b-5 under the Exchange Act. If a fund and its portfolio manager purchase or sell securities in the same company, the portfolio manager may have engaged in a "joint transaction" with the fund in violation of section 17(d) of the 1940 Act and rule 17d-1 under the Act. If a portfolio manager causes a fund to purchase particular securities in exchange for any compensation (in the form of securities, private investment opportunities, favorable trading terms, or other similar benefits), the manager would violate section 17(e) of the 1940 Act, which prohibits any portfolio manager or other fund insider, acting as agent, from receiving compensation from outside sources in exchange for the purchase or sale of any property to or from an investment company.

Like the provisions of the 1940 Act, the Exchange Act, and the Securities Act, described above, certain provisions of the Advisers Act apply to portfolio managers'

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[24] As explained in the text, rule 17j-1 applies to registered investment companies and their investment advisers and principal underwriters. Unless the context requires otherwise, the term "fund" as used in this Report includes any entity subject to rule 17j-1.

[25] Release No. 11421, *supra* note 21.

personal investment activities. An investment adviser whose portfolio manager or other employees engage in abusive investing, for instance, would violate section 206 of the Advisers Act, which prohibits investment advisers from engaging in certain fraudulent conduct and imposes a strict fiduciary duty on all advisers.

B. Personal Investing and the Division's Inspection Program

The Division's investment company inspection staff has played an integral role in the implementation of rule 17j-1 since the rule's adoption.[26] Through its inspection program, the Division regularly monitors the fund industry's compliance with the rule, as well as with the Commission's other rules governing investing by fund access persons. The review of access persons' securities transactions records is an essential component of all inspections.

During every fund inspection, Division examiners review a sampling of access persons' securities transactions. In addition, examiners typically: review the fund's code of ethics to determine whether it is adequate given the fund's investment operations; evaluate the adequacy of personal transaction reporting procedures; verify that an appropriate person has reviewed the personal trading reports submitted by access persons; and analyze the sample of personal transactions to check compliance with the fund's code and, more generally, to detect unlawful trading activities.

To date, the Division's inspection program has not revealed a significant number of abusive transactions by fund access persons. Although, as explained in detail below, this conclusion is supported by the data collected by the Division in its special examination of the 30 fund groups, the Division notes that inspections conducted prior to September 1993 may not accurately indicate the extent of abusive trading by fund access persons. During the three-year period prior to September 1993, the Division's inspection program focused a significant part of its efforts on money market funds, which typically would not be expected to raise issues of abusive personal trading.[27] In addition, for many years the Division's inspection program has been hampered by a lack of resources, which in turn has limited the number of personal transactions that the Division's inspectors could examine. The Division anticipates that its decision to change the emphasis of the inspection program from money market funds to all types of funds, together with the Commission's recent decision to allocate greater resources to the program, will enhance the program's ability to ensure compliance with rule 17j-1.[28]

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[26] The inspection program served as an impetus to the Commission's adoption of rule 17j-1 in 1980. The Commission said that it had determined to adopt the rule because "[t]hrough its examination program, the Commission has become aware of an increasing number of situations involving parallel trading by individuals with knowledge regarding transactions anticipated or engaged in by registered investment companies." Release No. 11421, *supra* note 21.

[27] Under existing Commission rules, money market funds must limit their investments to high quality, short-term debt instruments. These instruments generally do not present opportunities for front-running or other abusive transactions by access persons.

[28] *See* U.S. Securities and Exchange Commission Budget Estimate Fiscal 1995, at IV-6 (Feb. 1994) (stating that the focus of the Division's investment company inspection program would shift to small and medium fund complexes and that the inspection staff would increase by 54 staff years over 1993); *see also* Ellyn Spragins, *Much Ado About . . .*, Newsweek, Sept. 5, 1994, at 48 ("If corruption were rampant, it would likely show up among smaller, newer fund companies -- the focus of this year's SEC inspections.").

C. Personal Investing and the Commission's Enforcement Program

Like the Division's investment company inspection program, the Commission's enforcement program serves as a means of ensuring compliance with the Commission's rules on personal investing. As Chairman Levitt has said of the program: "[W]e will be, as we have always been, vigilant in our efforts to detect abusive trading practices by portfolio managers [and] we will not hesitate to take action against any portfolio manager whom we find to have engaged in these practices."[29]

The activities of fund access persons have been the subject of a number of recent Commission actions. These actions generally have involved abusive practices other than front-running. Three recent cases -- *In re Strong/Corneliuson Capital Management*,[30] *In re Kemper Financial Services*,[31] and *In re Embry*[32] -- highlight the Commission's efforts to deter investment advisers and their employees from engaging in abusive personal investment activities.

In *Strong/Corneliuson*, the Commission alleged that an investment adviser and two of its principals violated certain affiliated transaction provisions of the 1940 Act in connection with a number of securities transactions between registered funds managed by the adviser and an unregistered offshore investment company managed by the adviser in which the principals had a substantial undisclosed ownership interest. The Commission also alleged that the adviser and its principals had violated the antifraud provisions of the Advisers Act by acting inconsistently with the stated policy in the adviser's disclosure brochure provided to clients that the adviser and its principals would not invest in securities that it recommended to clients. In settling the action, the adviser and its two principals consented to censures and were subjected to cease and desist orders, and the adviser agreed to adopt and maintain comprehensive procedures to review and authorize all personal securities transactions in which the adviser or any of its access persons engage. The adviser also agreed to reimburse the funds almost $450,000 for pricing errors in certain of the securities transactions at issue. Finally, the adviser agreed to an unprecedented condition under which it may not serve as investment manager of a registered investment company unless a specified percentage, exceeding the percentage otherwise required under the 1940 Act, of the company's directors or trustees are non-interested persons of the adviser.[33]

Kemper involved an alleged misallocation of transactions in financial futures contracts between two registered investment companies managed by a Kemper employee and an account partially managed by the same employee and in which the employee had a financial interest. In *Kemper*, the Commission alleged that the investment adviser of two registered

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[29] Letter from Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Feb. 9, 1994).

[30] Investment Advisers Act Release No. 1425 (July 12, 1994).

[31] Investment Advisers Act Release No. 1387 (Oct. 20, 1993).

[32] Investment Advisers Act Release No. 1382 (Sept. 16, 1993).

[33] Sections 10(a) and 2(a)(19) of the 1940 Act, read together, require that at least 40% of an investment company's directors be non-interested persons of the company's investment adviser. The Commission increased this figure to 60% for Strong/Corneliuson.

investment companies caused violations of the provisions of the 1940 Act prohibiting self-dealing,[34] and failed to supervise one of its fund managers with a view to preventing his violations of those provisions. In particular, the Commission alleged that the fund manager placed the two investment companies that he managed at a disadvantage by allocating favorable transactions in futures contracts to an employee benefit plan account in which he had an interest and less favorable transactions to the two investment companies. In settling the Commission's action, the investment adviser agreed to a censure and the imposition of a cease and desist order. Moreover, the adviser agreed to pay $9.2 million into a settlement fund for distribution to the funds' shareholders, and agreed to undertake certain remedial measures to correct its procedures for the allocation of investment transactions.

In *Embry*, the sole owner and chief executive officer of an investment adviser, and fund manager for three registered investment companies, profited at the expense of his clients by engaging in numerous undisclosed personal securities transactions. In particular, the fund manager: received lucrative investment opportunities by purchasing high risk bonds for several of his clients, while purchasing common stock of the same issuers for himself; acted on several occasions as a principal in securities transactions with his clients without disclosing the capacity in which he was acting and without obtaining their consent; traded jointly, or in a block, with clients to obtain lower prices, and then resold the securities at a pre-arranged markup, resulting in substantial profit to himself; and failed to report over 750 of his personal securities transactions as required by rule 17j-1. In an administrative proceeding, the Commission ordered the fund manager to make no personal securities transactions unless (1) he retained an independent consultant and adopted the consultant's recommendations for improved compliance systems at the adviser, and (2) the consultant audited for five years the fund manager's personal securities transactions and the adviser's operations.[35]

The seriousness with which the Commission views the issue of abusive personal investing by fund personnel is shown not only in the *Strong*, *Kemper*, and *Embry* cases, but also in a number of other administrative proceedings brought by the Commission against advisers failing to adhere strictly with the requirements of rule 17j-1. The Commission has

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[34] Section 17(a) of the 1940 Act prohibits an affiliated person of a registered investment company from buying from or selling to the company any securities or other property. Section 17(d) of the 1940 Act and rule 17d-1(a) under the 1940 Act prohibit an affiliated person of a registered investment company from effecting any transaction in connection with a joint enterprise or other joint arrangement in which the company is a participant.

[35] Abusive personal investing also has been the subject of a number of court cases. *See, e.g.*, *United States v. Ostrander*, 792 F. Supp. 241 (S.D.N.Y. 1992), *aff'd* 999 F.2d 27 (2d Cir. 1993) (manager of high-yield bond fund who accepted investment opportunities in exchange for investing fund assets in certain securities sentenced to prison term and made to pay substantial fine); *United States v. Griggs*, Crim. No. 445 (S.D.N.Y. May 21, 1992) (analyst employed by an investment adviser entered guilty plea in connection with a scheme in which outside investor profited on information received from the analyst with respect to the adviser's recommendations of high-yield debt securities and the probable timing of fund purchases); *SEC v. Bayse*, Civ. No. 92-0549 (S.D.N.Y. Jan. 23, 1992) (manager of high-yield bond fund who failed to report over 100 personal trades and who accepted investment opportunities in exchange for investing fund assets in certain securities consented to a permanent injunction against future violations of several provisions of the 1940 Act, including section 17(j) and rule 17j-1, and the Advisers Act). The Commission subsequently barred each of Ostrander, Griggs, and Bayse from associating with any investment company, investment adviser, broker, dealer, or municipal securities dealer. *See* Investment Advisers Act Release Nos. 1371 (May 3, 1993) (Ostrander), 1311 (May 28, 1992) (Griggs), and 1301 (Feb. 26, 1992) (Bayse).

brought actions, for example, alleging the failure of funds to adopt codes of ethics and the failure of access persons to submit required reports.[36]

D. Recent Media and Congressional Attention to Personal Investing

Fund managers' personal investment activities became the focus of media attention early this year after Invesco Funds fired a prominent manager for allegedly failing to report a number of his personal securities transactions as required under both the 1940 Act and the Advisers Act.[37] Less than two weeks later, *The Wall Street Journal* reported that two funds managed by the same individual had purchased the stock of a small Canadian biotech company for which the manager served as director and whose stock he had personally acquired at very low prices.[38]

At about the same time of the Invesco firing, the media reported that Fidelity, the country's largest fund complex, had recently amended its internal rules on personal investing.[39] *The Washington Post* reported that Fidelity's rule changes were prompted by several instances of front-running in small company stocks by employees of Fidelity's investment department.[40] In response to *The Washington Post* article, Edward J. Markey, Chairman of the House Subcommittee on Telecommunications and Finance, wrote to Chairman Levitt seeking information regarding "the practice of mutual fund managers trading for their personal accounts, and the potential conflict of interest that poses in their

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[36] In 1992, for example, the Commission ordered the corporate adviser to a large family of mutual funds to implement procedures reasonably designed to ensure compliance with rule 17j-1, including employment of a full-time compliance officer. The adviser's access persons consistently had submitted their quarterly reports late, in many cases as much as one year after the reports were due. *In re First Investors Management Co.*, Investment Advisers Act Release No. 1316 (June 12, 1992). In 1983, the Commission sanctioned a mutual fund access person who, over a three-year period, reported only 35 of 250 securities transactions in which he had a beneficial interest. In addition, at least 15 transactions occurred at or about the time that one or more of his employer's advisory clients were trading, or considering trading, the same security. The Commission suspended the access person from associating with any registered investment adviser or registered investment company, and prohibited him from accepting any new advisory clients, for six months. *In re Farrer*, Investment Advisers Act Release No. 847 (Mar. 31, 1983). *See also In re Cummings*, Investment Advisers Act Release No. 1304 (Mar. 23, 1992) (failure to adopt code of ethics); *In re Bench*, Investment Advisers Act Release No. 1202 (Sept. 19, 1989) (failure to maintain copies of personal transaction reports); *In re Frantzman*, Investment Company Act Release No. 16349 (Apr. 5, 1988) (failure to report personal transactions and failure to maintain copies of transaction reports); *In re Guilden*, Investment Company Act Release No. 15578 (Feb. 13, 1987) (failure to report personal transactions); *In re Lubart*, Investment Company Act Release No. 15577 (Feb. 13, 1987) (same); *In re Flusfeder*, Investment Company Act Release No. 15575 (Feb. 12, 1987) (same); *In re Leibowitz*, Investment Company Act Release No. 14310 (Jan. 10, 1985) (failure to adopt code of ethics).

[37] *E.g.*, Robert McGough and Sara Calian, *Invesco Funds Fires Kaweske, a Star Manager*, Wall St. J., Jan. 6, 1994, at C1.

[38] Sara Calian and Suzanne McGee, *Kaweske Scored on Canada Play Long Before Funds Did*, Wall St. J., Jan. 17, 1994, at C1.

[39] *See, e.g.*, Brett D. Fromson, *Fund Managers' Own Trades Termed a Potential Conflict; Biggest Mutual Fund Firm Tightens Rules*, Wash. Post, Jan. 11, 1994, at A1.

[40] *Id.* at A8.

work for the funds they manage."[41] Chairman Levitt answered Chairman Markey's inquiry by a letter dated February 9, 1994, accompanied by a memorandum prepared by the Division describing the existing provisions of law that prohibit abusive trading by fund managers and other access persons. Chairman Levitt also said that the Divisions of Investment Management and Enforcement would be conducting a special examination of 30 fund groups in an effort to analyze the fund industry's current policies and practices relating to personal investment activities of access persons.[42] That examination serves as the principal basis of this Report.

The articles relating to Invesco and Fidelity, as well as the correspondence between Congress and the Commission, led to a number of press reports on the investment activities of mutual fund investment personnel. These articles focused on several different issues. Some, for instance, described various abusive transactions in which fund managers might engage, including front-running, participating on favorable terms in initial public offerings ("IPOs") or private placements, and investing in companies on whose boards the fund managers serve.[43] Other articles noted that fund shareholders may not fully understand the potential conflicts of interest regularly faced by the managers of their funds[44] and reported that many fund groups were unwilling to make the terms of their codes of ethics available to the public.[45] Finally, a number of articles raised concerns about the ethical standards maintained by the fund industry and suggested that a total ban on personal investing by fund personnel might be the only way to ensure high moral conduct by industry participants.[46]

E. The ICI Report

Shortly after Chairman Levitt's letter to Chairman Markey described above became public, the ICI, the national association of the American investment company industry, formed a special advisory group "to review practices and standards governing personal investing and to make any recommendations deemed necessary or desirable in the interest of

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[41] Letter from Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce, to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission (Jan. 11, 1994).

[42] Levitt letter, *supra* note 29.

[43] *E.g.*, Tracey Longo, *SEC Places Front Running On the Front Burner*, Financial Planning, Feb. 1994, at 24; Sara Calian, *Mutual Fund Managers Can Often Get Part of the Action in Private Placements*, Wall St. J., Jan. 28, 1994, at C1; Robert McGough, *Mutual-Fund Managers Face Conflicts of Interest While Serving as Directors*, Wall St. J., Jan. 21, 1994, at C1

[44] *See* Fromson, *supra* note 39, at A1 ("Unknown to most of the nation's 38 million mutual fund shareholders, many of the fund managers who do the investing use information available only to them and other big investors to speculate for their personal accounts.").

[45] Christopher Phillips, *Keeping Your Fund Manager Honest*, Kiplinger's Personal Finance Magazine, April 1994, at 57, 58 (noting that "[f]unds are tight-lipped about their ethics codes" and that, in response to the author's request, a few of the largest fund groups sent summaries of their codes, while others would not discuss their codes at all, or discussed them only generally, without giving specifics); John Accola, *Only 1 of Top 4 Mutual Fund Firms Reveals Ethics Codes*, Rocky Mountain News, Feb. 6, 1994, at 93A ("Only one of Denver's four biggest mutual fund companies has agreed to a *Rocky Mountain News* request to provide a copy of their internal guidelines governing personal trading for officers and portfolio managers.").

[46] *Mutual Funds Need Tighter Rules*, Business Week, Feb. 14, 1994, at 134.

investors."[47] The advisory group, in a report issued on May 9, 1994 (the "ICI Report"), concluded that "an across-the-board prohibition on personal investing [would be] unnecessary, unfair and, in the final analysis, contrary to the interests of investors."[48] Notwithstanding this conclusion, the ICI Report recommends that all participants in the fund industry adopt certain policies and procedures governing personal investment activities of fund personnel, short of a total ban, designed to address "recognized potential for abuse."[49] On June 30, 1994, the ICI's Board of Governors unanimously endorsed the conclusions and recommendations in the Report and urged all ICI members, whose funds hold approximately 95% of total industry assets, to implement the Report's recommendations by January 1, 1995.

The ICI Report recommends, among other things, that each fund adopt the following restrictions and procedures with respect to the personal investing and other activities of its investment personnel:[50]

- investment personnel should be prohibited from acquiring any securities in an IPO and should be strictly limited in their ability to participate in private placements of securities;

- each fund manager should be subject to "blackout periods" during which he would be prohibited from buying or selling securities for seven days before and after the fund he manages purchases or sells the same securities, and other investment personnel should be prohibited from buying or selling securities on a day during which the fund or any other fund in the same fund group has a pending buy or sell order for those securities;

- investment personnel should be prohibited from profiting from the purchase and sale, or the sale and purchase, of the same securities within 60 days, and any profits realized on any such short-term trades should be required to be disgorged;

- investment personnel should be prohibited from serving on the boards of directors of publicly traded companies, absent prior authorization based upon a determination that the board service would be consistent with the interests of the fund and its shareholders;

- investment personnel should be prohibited from receiving any gift or other thing of more than *de minimis* value from any person or entity that does business with, or on behalf of, the fund;

- investment personnel should be required to pre-clear all personal securities transactions;

- investment personnel should be required to disclose to the fund all personal securities holdings at the commencement of employment and annually thereafter;

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[47] Report of the Advisory Group on Personal Investing (May 9, 1994) at (i).

[48] *Id.* at 25.

[49] *Id.*

[50] As used in the ICI Report, the term "investment personnel" is essentially synonymous with the term "access person" as defined in rule 17j-1. *See supra* note 23.

- investment personnel should be required to instruct their brokers to send copies of trade confirmations and account statements directly to their employers;

- appropriate procedures should be implemented by the fund to monitor personal investment activity by access persons after pre-clearance has been granted;

- access persons should be required to certify annually that they have read and understood the fund's code of ethics and recognize that they are subject to it; and

- fund management should submit to the fund's board of directors or trustees an annual report summarizing, among other things, any changes made during the past year to the fund's procedures governing personal investing by access persons and identifying any violations of the procedures by an access person requiring significant remedial action during the past year.

The ICI Report also recommends that funds disclose in their prospectuses or, at a minimum, their statements of additional information,[51] the policies applicable to personal investing by their access persons. In addition, the Report recommends that the NASD adopt a rule requiring all broker-dealers to notify a registered investment adviser when any of the adviser's employees opens a brokerage account.

Although it contemplates that "substantive standards [relating to personal investing] should apply across the industry," the ICI Report acknowledges that "[i]ndividual investment companies, of course, may elect to implement more rigorous standards should these be deemed more appropriate in a specific case."[52] Moreover, the Report states that a guiding principle in drafting its recommendations was that "flexibility to allow investment companies to tailor restrictions to unique or exceptional circumstances is critical to successful implementation of [the] standards [reflected in the recommendations.]"[53] Reflecting this principle, the Report does not advocate that the Commission adopt the Report's recommendations as rules under the 1940 Act.

III. EXAMINATION OF 30 FUND GROUPS

A. Request for Information

In his letter to Chairman Markey dated February 9, 1994, Chairman Levitt reported that, to ensure that the confidence of the public in the investment company industry is well-founded, "the Divisions of Investment Management and Enforcement, through a written request for information, are examining fund managers' personal trading practices to ascertain the extent to which such trading occurs and how closely these trades are linked to a fund's

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[51] Forms N-1A and N-2, the forms for registering open-end and closed-end investment companies, respectively, under the Securities Act and the 1940 Act, provide for a prospectus and a separate "statement of additional information" ("SAI"). The SAI, which is available upon request, is designed to provide shareholders with information about the registrant that is not required to be included in the prospectus but that may be of interest to at least some investors.

[52] ICI Report, *supra* note 47, at 26.

[53] *Id.*

portfolio."[54] The special examination was begun in February and March of this year when the two Divisions sent letters to 30 fund groups[55] requesting the following documents and information for calendar year 1993:

- the identity of each fund in the group and each individual who managed a fund;

- a copy of the code of ethics for each fund and its adviser, any other written or unwritten policies regarding personal investing, and descriptions of any violations of those codes or policies;

- the number of personal transactions made by each fund's manager; and

- specific information about certain fund manager personal transactions and certain fund portfolio transactions, as more fully described in Part III.C.1. of this Report.[56]

B. Codes of Ethics: Content and Compliance

Although the 30 codes of ethics reviewed by the Commission's staff had certain provisions in common, no two codes were identical. Exhibit B to this Report contains a statistical summary of the various provisions found in the codes of ethics reviewed by the staff.

The most common restriction placed on personal trading (21 of the 30 fund groups) prohibits an access person of a fund from purchasing or selling any securities that he knows are being considered for purchase or sale, or are being purchased or sold, by the fund. In addition, 15 of the 30 groups impose a blackout period that prohibits trading securities for a specified time before and/or after one of the funds in the group has purchased or sold the same securities. The length of the blackout period varies from one day to 30 days, and the restriction frequently applies to all employees rather than being limited to access persons. Five fund groups prohibit or restrict employees from purchasing securities in an IPO; nine other groups prohibit or restrict employees from purchasing IPOs that qualify as "hot issues."[57]

All 30 funds, as mandated by rule 17j-1, require their access persons (and frequently other employees as well) to report their personal transactions. Although the rule requires only quarterly reporting, more than half of the funds require contemporaneous reporting, accomplished either by requiring employees to trade through approved (and usually affiliated) broker-dealers, or by requiring employees (or their broker-dealers) to provide duplicate confirmations of all personal securities transactions. Seventeen of the 30 fund groups require employees to pre-clear all personal securities transactions. Seven others

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[54] Levitt letter, *supra* note 29.

[55] Exhibit A to this Report includes copies of the February and March letters. The criteria used to select the 30 fund groups are discussed in Part III.C.3 of this Report.

[56] The staff requested information about personal transactions by fund managers, and not other access persons, because it concluded that managers generally have the most information about, and control over, impending fund transactions, as well as the financial ability to act on that information and control.

[57] The term "hot issue" is defined in the NASD's Rules of Fair Practice. *See infra* note 121.

require pre-clearance for certain defined categories of transactions, such as options and futures, or securities on a "restricted" list.

Most of the 30 codes of ethics reviewed by the staff provide for employees to receive a copy of the code upon commencement of employment. Many funds distribute copies annually thereafter, and each employee usually must certify each time that he has received a copy and has read and understood it. When a fund amends its code, it typically distributes a copy of the amended code to all employees. It appears that a number of funds regularly review their codes to determine whether changes are appropriate. At least six of the 30 fund groups amended their codes in 1993, including four fund groups that added a pre-clearance requirement.

The oversight of employees' compliance with a fund's code of ethics is usually a function of the fund group's compliance department. Compliance responsibilities often include determining whether to pre-clear a trade, or checking an employee's duplicate confirmations against his quarterly report of transactions to identify discrepancies.

In its review of the records of the 30 fund groups, the staff found that fund groups often deal severely with employees who violate codes of ethics provisions. Five of the 30 fund groups reported code violations by 12 employees; the remaining 25 fund groups did not report any code violations.[58] Most of the violations involved failure to pre-clear a trade. Nine of the 12 employees had their trades cancelled, disgorged profits, or were required to sell their positions at a loss. The three others received written reprimands, and one of them also was fined $600. Exhibit C of this Report contains a description of each violation reported, and the remedial action taken.

C. Analysis of Trading Data

1. Introduction

In response to the staff's requests for information, the 30 fund groups submitted data about their funds' portfolio transactions and their fund managers' personal transactions during 1993. As of the end of 1993, the 30 fund groups employed 622 portfolio managers and had $521 billion under management in 1,053 funds. As of the same time, these fund groups managed approximately 36.5% of the assets, and constituted 28.4% of the funds, in the investment company industry, excluding unit investment trusts, money market funds, and funds investing primarily in United States government securities.[59]

In conducting its examination, the staff requested information on three categories of personal securities transactions made by fund managers:

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[58] The staff limited its request for information about code violations to those violations that prompted a fund to take "significant remedial action" against an employee. In its request for information, the staff defined significant remedial action to include firing, suspending (with or without pay), reassigning, or demoting the employee; requiring the reversal of a trade or the disgorgement of profits; formal censure; and any other remedial action that might affect the employee's promotion opportunities. This request was designed to keep the quantity of information manageable by eliminating the need for funds to report certain violations, such as the occasional late filing of quarterly reports.

[59] Rule 17j-1 currently excludes money market instruments and United States government securities from its definition of "securities." *See supra* note 22. Unit investment trusts were excluded from our special examination because they are not managed investment vehicles.

(a) all personal transactions;

(b) personal transactions that were "matching trades," which were defined to include any personal transaction that preceded by ten days or less a transaction by a related fund on the same side of the market (i.e., buy/buy or sell/sell) in the same or related securities;[60] and

(c) matching trades that were "fund matching trades," which were defined to include any matching trade in which the related fund was a fund whose portfolio securities were selected by the fund manager.

Requests (b) and (c) were designed to identify potential instances of front-running by fund managers.[61] Fund matching trades were considered particularly relevant to the Division's analysis because managers are likely to have more information about their own funds than about other funds in a fund group, and thus have more of an opportunity to profit by buying or selling ahead of their own funds.

Other information requested by the staff included a listing of fund purchases of any equity securities that, at the time of the purchase, were held by that fund's manager (regardless of the time lapse between the purchases). As noted below in Part III.C.8 of this Report, these purchases can result in potential conflicts of interest between a fund and its manager.

2. Summary of Findings

The data submitted by the 30 fund groups shows that, generally, fund managers do not invest extensively for their personal accounts. In 1993, 43.5% of the fund managers employed by the groups did not buy or sell any securities; 75% engaged in ten or fewer transactions. The median number of personal transactions per manager for 1993 was two.

The data also indicates that fund managers generally avoid purchasing or selling securities that might cause a conflict of interest. Only about one of every 21 personal transactions, for example, was a matching trade and only about one of every 49 personal transactions was a fund matching trade.[62] In the majority of matching and fund matching trades, the manager did not receive a better price than the fund.

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[60] A "related fund" was defined as any fund whose portfolio securities were selected by the fund manager, or any other fund in the same fund group. For purposes of the examination, two securities were deemed "related" if the value of one security was related to the value of the other. For example, options or warrants to purchase common stock, convertible debt, and convertible preferred stock were deemed related to the underlying common stock. For convenience, all references hereafter to "the same securities" include related securities, unless specifically noted otherwise.

[61] In the interest of collecting a manageable quantity of relevant data, the staff asked the fund groups to exclude equity securities contained in the Standard & Poor's 100 Composite Stock Index from the data submitted in response to requests (b) and (c). Front-running typically contemplates the ability of a fund's trade to move the price of securities. Because of the degree of liquidity of the markets for S&P 100 stocks, it would seem highly unlikely that a single fund's purchase or sale transaction would affect the price of these stocks.

[62] Exhibit E illustrates, in pie chart form, the relative number of matching trades and fund matching trades in relation to the total number of personal transactions.

The investment activities of certain of the fund managers employed by the 30 fund groups were inconsistent with the general trends. A small percentage of the fund managers invested very actively for their personal accounts. More significantly, some managers (usually the most active investors) made a large number of matching trades. The data also shows that many of the managers who were the most active investors and who were responsible for the most matching trades (including fund matching trades) were associated with four fund groups.

3. Limitations of the Data

The data received from the 30 fund groups must be considered in the context of certain limitations. First, although the staff sought to obtain a broad cross-section of the fund industry, the 30 fund groups selected were not selected randomly and are not necessarily representative of the industry as a whole. The staff selected an approximately equal number of small, medium, and large fund groups based on assets under management,[63] and attempted to select funds that employed a variety of investment strategies and objectives. Other selection criteria included geographic location and type of sponsoring organization (e.g., broker-dealer, investment adviser, or bank). Three fund groups were selected based on the staff's experience, through prior inspections, that the groups' managers had invested actively for their personal accounts. The three groups were among the four fund groups examined whose managers invested most frequently and were responsible for the highest number of matching trades and fund matching trades. The Division believes that, if all 30 fund groups had been selected without regard to how frequently their managers had traded in the past, the data from the special examination may have reflected fewer personal transactions, matching trades, and fund matching trades.

Second, the staff's analysis is based on the data as submitted by each fund group, except that the staff in certain instances treated serial purchases or sales of the same securities as a single transaction.[64]

Finally, certain of the 30 fund groups employ unaffiliated (and separately located) subadvisers to manage all or a portion of their funds' assets. Two fund groups contended that it was unnecessary to report as matching transactions the personal transactions of portfolio managers employed by unaffiliated subadvisers that matched the portfolio transactions of funds in the groups managed by other advisers ("unaffiliated matching trades"). The two fund groups represented that the unaffiliated subadvisers did not share information about securities under consideration for purchase or sale with advisers of other funds in the group. The staff concluded that unaffiliated matching trades in all probability

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[63] For purposes of the examination, the staff considered fund groups to be small, medium, or large based on whether they managed less than $1 billion, between $1 billion and $10 billion, or more than $10 billion, respectively.

[64] To avoid overstating the number of personal transactions and matching trades, the staff consolidated multiple reported transactions into one transaction whenever multiple transactions resulted from a single investment decision. This occurred in two situations -- when a manager purchased or sold the same security for multiple accounts in which he had a beneficial interest, and when a manager's single order to purchase or sell a security on behalf of a fund was executed in multiple transactions. Each group of consolidated transactions was effected by the same broker, within approximately 24 hours, and at approximately the same price. We consolidated the transactions of 10 fund groups that were responsible for the overwhelming majority of matching trades and fund matching trades (82% and 86%, respectively). The consolidation had no material effect on the outcome of the examination, although had the staff combined transactions for all 30 fund groups, the data would reflect fewer matching trades and fewer fund matching trades.

were coincidental and therefore did not reflect front-running or any other abusive practice, and permitted the two fund groups to exclude such trades from the matching trades they reported. Some of the other 28 fund groups likewise employ unaffiliated subadvisers to manage their funds, but did not seek staff clarification on the manner in which to report subadviser transactions. If those other groups have in fact reported unaffiliated matching trades as matching trades, the number of matching trades reported may be overstated.

4. Exclusion of One Fund's Data

The data presented below excludes data for one of the funds in one of the 30 fund groups. The fund in question is managed in a style that is atypical of the fund industry. The staff concluded, after close analysis of the fund's operations and investment history and an on-site inspection of two of its subadvisers, that this management style resulted in personal trading data that was dramatically inconsistent with the other 1,052 funds covered by the special examination and that was not necessarily representative of the fund industry.

The fund in question was designed to provide individual investors with the opportunity to invest with advisory firms that otherwise manage money exclusively for wealthy individuals and institutional investors. The fund's investment adviser, an affiliate of the fund's sponsor, allocates a portion of the fund's assets to each of four subadvisers who are unaffiliated with the fund's adviser and with each other. None of the four subadvisers, and none of the four individuals who managed the fund's portfolio on behalf of the subadvisers, had managed the assets of a registered investment company prior to serving the fund. In managing a portion of the fund's assets, two of the individuals employed investment strategies identical to those employed on behalf of their other advisory clients. Those strategies contemplated the two managers' typically purchasing and selling the same securities for all of their clients, as well as for their personal accounts, at the same time. Such co-investment by a manager is characteristic of managers of hedge funds and other institutional investors, but is not a strategy generally followed by managers of registered investment companies.[65]

The investment strategy followed by two of the fund's managers appears to have resulted in personal investment data for these managers that is inconsistent with the data collected from the managers of the other 1,052 funds examined. The two managers each engaged in over 1,400 personal securities transactions in 1993, or almost three times the number of the next most active manager in the group of 30 funds examined. The two managers also had a total of more than 1,000 matching trades, each of which also constituted a fund matching trade. By contrast, the 618 managers not associated with the fund in question whose investments were examined by the staff had a total of only 471 matching trades, of which 201 were fund matching trades.

Because the trading data from the managers of this one fund deviates so greatly from the data from the other managers, and because the fund may not be representative of the fund industry generally, the Division concluded that it was appropriate to exclude this fund in presenting the results of the special examination. In the Division's view, including this fund's data would diminish the significance and utility of the data submitted by the other 1,052 funds examined. To illustrate the effect of the data submitted by the fund in question,

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[65] Co-investment may not be characteristic of registered investment companies because of difficult interpretive issues raised by the practice under section 17(d) of the 1940 Act.

Exhibit D of this Report compares the data for the other 1,052 funds with the data for all 1,053 funds included in the examination.

The staff conducted an on-site inspection of the two subadvisers whose managers' personal investment activities were atypical of the other managers whose investments were reviewed. The inspection of one subadviser did not reveal evidence of abusive trading activities. The inspection of the other subadviser has not yet been completed.

5. Securities Transactions of the Fund Managers Examined

The data provided to the staff revealed that a substantial majority of the fund managers employed by the 30 fund groups examined either did not buy or sell securities in 1993, or did so infrequently; only a small percentage of managers invested actively for their personal accounts. The 30 fund groups reported a total of 9,843 personal securities transactions by 618 fund managers during 1993.[66] Of these managers, 269, or 43.5%, reported no personal transactions. The median number of personal transactions for all 618 fund managers was two.[67] In addition, personal transactions were concentrated among a small number of managers. Ten managers had over 200 transactions each; two of these individuals had over 500 transactions each. The five managers who invested most actively accounted for almost 25% of all personal transactions included in the data received by the staff; the 10 most active managers accounted for over 37% of all personal transactions, and the 20 most active managers accounted for 50% of all personal transactions. The following table summarizes the number of fund managers' personal securities transactions:

Number of Personal Transactions	Number of Managers
0	269 (43.5%)
1 - 2	70 (11.3%)
3 - 10	124 (20.1%)
11 - 20	59 (9.5%)
21 - 40	43 (7.0%)
41 - 100	37 (6.0%)
> 100	16 (2.6%)

Significantly, most of the active investors were concentrated among a few fund groups. Of the 20 managers who had the greatest number of personal transactions, 16 were associated with four fund groups. As the following table illustrates, fund managers associated with those four fund groups accounted for almost half of all personal securities transactions reflected in the data received by the staff:

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[66] Although it received data with respect to 622 fund managers, the staff excluded the data from the four managers of one fund, for the reasons set forth in Part III.C.4 above.

[67] By contrast, the average number of personal securities transactions per manager was 16. The wide disparity between the median and average figures results from a small number of fund managers engaging in a substantial number of personal securities transactions. This result may be due, in part, to the selection of certain fund groups based on the staff's experience that the groups' managers had, in the past, invested actively for their personal accounts. *See supra* Part III.C.3. The Division concluded that, in this instance, the typical fund manager's personal investment activities are presented more accurately by using the median instead of the average.

Number of Fund Groups	Number (%) of Managers	Number (%) of Personal Transactions	Avg. Number of Personal Transactions Per Manager
4	96 (15.5%)	4,807 (48.9%)	50.0
26	522 (84.5%)	5,036 (51.1%)	9.6

6. Matching Trades

Of the 9,843 personal transactions reported to the staff, 471 (4.8%) were matching trades.[68] The staff's examination revealed that a sizable majority of fund managers had no matching trades, and that those managers who had such trades had only a small number of them. Over 80% of the 618 fund managers in our sample had no matching trades at all. The average number of matching trades for all 618 fund managers was less than one. The following chart illustrates that the fund managers whose transactions were reviewed by the staff generally did not actively buy or sell securities ahead of a related fund:

Number of Matching Trades	Number of Managers
0	504 (81.6%)
1 - 2	73 (11.8%)
3 - 4	16 (2.6%)
5 - 10	17 (2.8%)
11 - 20	4 (0.6%)
> 20	4 (0.6%)

The data showed that a small number of managers engaged in a large percentage of matching trades. Four managers accounted for 30% of all matching trades; twelve managers accounted for just under 50% of all matching trades. Eight of those 12 managers (and all of the four managers who had the most matching trades) were associated with four fund groups -- the same four groups whose managers had the highest concentration of personal securities transactions. The following table illustrates the concentration of matching trades among these four fund groups:

Number of Fund Groups	Number (%) of Managers	Number (%) of Matching Trades	Avg. Number of Matching Trades Per Manager
4	96 (15.5%)	235 (49.9%)	2.45
26	522 (84.5%)	236 (50.1%)	0.45

For each matching trade involving equity securities (433 of the 471 matching trades), the staff examined the length of time between the manager's transaction and the fund's transaction, and the difference in the respective transaction prices.[69] On average, fund

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[68] This number may overstate the actual number of matching trades. See the discussion in Part III.C.3 of this Report.

[69] In comparing the prices that funds and managers paid or received in matching trades, the staff focused on equity securities because the per share price of equity securities affords a basis for comparison. Because it would not be helpful in this context to compare the price of equity securities to the price of a warrant or option relating to the securities, the statistics cited in the table above relate to matching trades of the same securities only, and not to related securities. *See supra* note 60.

managers purchased or sold equity securities 3.4 days before a related fund, and did so at a less favorable price than the fund.[70] Notwithstanding the average statistics, fund managers received a better price than a related fund in 175 transactions (1.8% of the 9,843 personal transactions reported by the fund managers covered by the staff's examination). These 175 manager transactions consisted of 118 purchases and 57 sales. Favorable purchases by managers, on average, occurred 3.5 days before a matching fund transaction and the price per share paid by the manager was $1.24 less than the fund paid. Favorable sales by managers, on average, occurred 4.1 days before the matching fund trade and the price per share received by the manager was $1.47 more than the fund received. Approximately half of the matching trades in which the fund manager received a better price than a related fund were pre-cleared by the manager's employer.

7. Fund Matching Trades

The data collected by the staff revealed that, in 1993, the overwhelming majority of fund managers whose transactions were examined -- more than 90% -- had no fund matching trades, and most of those who had fund matching trades had only one or two of them. The following table summarizes these results:

Number of Fund Matching Trades	Number of Managers
0	570 (92.2%)
1	25 (4.1%)
2	8 (1.3%)
3 - 10	12 (1.9%)
11 - 20	2 (0.3%)
> 20	1 (0.2%)

The 30 fund groups reported 201 fund matching trades, or 2.0% of all personal securities transactions in 1993. A large percentage of the 201 fund matching trades was undertaken by a few managers. One manager, for example, had 60 fund matching trades and another had 20, accounting for 30% and 10%, respectively, of all fund matching trades. The four fund groups responsible for the highest concentration of personal transactions and matching trades also were responsible for more than two-thirds of all fund matching trades, as the following table illustrates:

Number of Fund Groups	Number (%) of Managers	Number (%) of Fund Matching Trades	Avg. Number of Fund Matching Trades Per Manager
4	96 (15.5%)	140 (69.7%)	1.46
26	522 (84.5%)	61 (30.3%)	0.12

The data collected shows a correlation between the size of a fund and the proportion of personal securities transactions by the fund's managers that are fund matching transactions. The proportion is considerably higher for fund managers associated with small

[70] Of the 295 matching trades that involved the purchase of the same equity securities by a fund manager and a related fund, the price per share paid by the manager averaged $0.10 higher than the fund paid. Similarly, of the 138 matching trades that involved the sale of the same equity securities by a fund manager and a related fund, the price per share received by the manager averaged $0.43 lower than the fund received.

and medium size fund groups (4.3% and 3.8%, respectively) than it is for those associated with large fund groups (0.7%).[71]

For each fund matching trade involving equity securities (183 of the 201 fund matching trades), the staff examined the length of time between the manager's transaction and the fund's transaction, and the difference in the respective transaction prices.[72] Like that relating to matching trades generally, the data for fund matching trades shows that, on average, managers purchased and sold securities at less favorable prices than their funds.[73] Notwithstanding the average statistics, fund managers received a better price than their funds in 69 transactions (less than 1% of the 9,843 personal transactions reported by the fund managers covered by the examination). The 69 manager transactions consisted of 46 purchases and 23 sales. Favorable purchases by managers occurred, on average, 3.7 days before a matching fund trade and the price per share paid by the manager was $1.03 less than the fund paid. Favorable sales by managers occurred, on average, 4.2 days before the matching fund trade and the price per share received by the manager was $1.90 more than the fund received.

8. Fund Equity Purchases of Securities Held by the Fund's Manager

The staff asked the 30 fund groups to identify all fund purchases of equity securities that, at the time of purchase, were held by the fund's manager ("matching fund equity purchases").[74] This request was designed to identify circumstances involving either of two potential conflicts of interest. First, a manager who causes his fund to purchase securities he holds may be attempting to increase the price of the securities. Second, a manager who holds the same securities as his fund may, in seeking to protect the value of his personal investment, not sell the securities held by the fund at a time most beneficial to the fund.

The number of matching fund equity purchases reported to the staff was small. Approximately one of every 34 fund equity purchases (2.9%) was a matching fund equity purchase. The number of matching fund equity purchases that raised potential conflict of interest situations was even lower, because many matching purchases involved actively

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[71] The staff believes that these results may indicate greater potential for compliance problems at smaller fund groups. The concern that smaller funds and new entrants to the fund industry may have less developed compliance programs caused the Division late last year to focus more of its inspection resources on these types of funds. *See supra* note 28 and accompanying text.

[72] *See supra* note 69.

[73] Of the 123 fund matching trades that involved the purchase of the same equity security by a fund manager and the fund he managed, the price per share paid by the manager averaged $0.24 higher than the fund paid. Similarly, of the 60 matching trades that involved the sale of the same equity securities by a fund manager and his fund, the price per share received by the manager averaged $0.99 lower than the fund received. On average, managers who purchased or sold stock in advance of their funds did so 3.5 days before their funds' transactions.

[74] The data presented with respect to matching fund equity purchases covers only 28 of the 30 fund groups examined by the staff. Two groups did not respond to this request because they could not obtain information about their managers' securities holdings before the managers began working for the groups. The inability of these fund groups to obtain information about their managers' pre-employment holdings underscores the need for a requirement that fund personnel disclose their securities holdings at the commencement of their employment with a fund or a fund's adviser. The Division is recommending that the Commission adopt such a requirement. See Recommendation 3 in Part V of this Report.

traded securities of large capitalization companies whose prices were unlikely to have been affected given the size of a fund's purchase.

The number of matching fund equity purchases as a percentage of a fund group's total equity purchases ranged from a low of zero to a high of 15.8%. The four fund groups whose managers accounted for the highest concentration of personal securities transactions, matching trades, and fund matching trades, were also among the fund groups with the highest percentages of matching fund equity purchases. The following table illustrates these findings:

Number of Fund Groups	Number (%) of Fund Equity Purchases	Number (%) of Matching Fund Equity Purchases	Avg. Pctg. of Matching Fund Equity Purchases
4	47,109 (20.0%)	3,991 (57.9%)	8.5%
24	187,909 (80.0%)	2,902 (42.1%)	1.5%

The staff found a correlation between the size of a fund group and the proportion of the group's matching fund equity purchases. Small groups had the highest proportion of matching fund equity purchases, 5.1%, medium groups had 3.0%, and large groups had 1.7%.

D. Need for Further Examinations

The vast majority of the fund managers subject to the staff's examination did not invest actively for their personal accounts, and invested infrequently or not at all in advance of a related fund. A few managers, however, engaged in a significant number of transactions, including numerous matching trades. At this time, the staff lacks sufficient information to assess whether these transactions involved front-running or other prohibited practices. The staff is in the process of obtaining additional information about these transactions, particularly those in which the manager received a better price than a related fund. In addition, the staff is examining the compliance programs of the four fund groups whose managers effected the most personal securities transactions, matching trades, and fund matching trades, and a significant number of matching fund equity purchases, to determine whether these groups exercised adequate oversight over the personal investment activities of their employees. If the Division's inspection staff finds evidence of abusive conduct or materially deficient procedures, it will refer those matters to the Division of Enforcement for further action.

IV. ANALYSIS OF CERTAIN ISSUES

In developing recommendations designed to enhance the existing rules governing the personal investment activities of fund access persons, the Division considered two key policy issues that have been raised by members of Congress, certain Commissioners, and numerous press articles. Those issues are: whether personal investing by access persons should be banned entirely and whether the standards of conduct recommended by the ICI Report, or other similar or comparable standards, should be made mandatory for all funds through Commission rules. For the reasons described below, the Division believes that the Commission should continue to follow its long-standing positions that personal investing by access persons should not be banned and that specific standards governing personal investing should not be mandated.

A. Banning Personal Investing

In a letter dated May 23, 1994, Representative John D. Dingell, Chairman of the House Committee on Energy and Commerce, asked the Commission to consider whether the practice of personal investing by fund access persons should be banned entirely.[75] Commissioner Roberts and Judge Stanley Sporkin, former director of the Commission's Enforcement Division, among others, have suggested that a ban may be appropriate.[76] At least one fund group reportedly has imposed a ban on certain access persons.[77]

Commentators have offered several reasons to support a ban on personal investing by fund access persons. First, some say that a ban is the only way to deal effectively with real or perceived conflicts of interest that exist when access persons invest for their own accounts.[78] Others contend that the fund industry must adhere to the highest possible ethical standards in light of the substantial number of investors, particularly new investors, now turning to mutual funds, and the substantial amount of assets now under the control of fund managers.[79] Still others have said simply that a ban may be the only way for the industry to retain its "squeaky clean" reputation.[80] Finally, some observers maintain that the time spent

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[75] Letter from John D. Dingell to Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, and Matthew Fink, President, Investment Company Institute (May 23, 1994).

[76] "Portfolio Manager Trading, Investment Adviser Fees and Bank Mutual Fund Activities," Remarks of Richard Y. Roberts, Commissioner, U.S. Securities and Exchange Commission, before the District of Columbia Bar and George Washington Univ. Merging Financial Markets Conference in Washington, D.C. (Mar. 25, 1994); "Does an Ethical Dilemma Exist in the Financial Services Industry?," Remarks of Stanley Sporkin, U.S. District Court Judge, before the Association of Investment Management & Research Conference in Washington, D.C. (Dec. 1, 1993).

[77] Berger Associates, an advisory firm that manages three public mutual funds with approximately $2.3 billion in assets, prohibits its fund managers from holding individual stocks in their personal accounts. Jonathan Clements, *Personal Trading is Common Among Fund Managers*, Wall St. J., Jan. 25, 1994, at C1.

[78] "Mutual Fund Directors: On the Front Line for Investors," Remarks of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, before the Mutual Funds and Investment Management Conference in Scottsdale, Arizona (Mar. 21, 1994), at 6 ("Many in the industry argue that trading by managers . . . create[s] only a perceptual problem. That is precisely the point. With millions of inexperienced investors leaving the safety of bank CDs for the expectation of higher returns in the mutual fund market, we can ill afford even the perception of conflict. . . . If I were a [mutual fund] director I would have reservations about trading by managers . . . .") (emphasis in original); B.J. Phillips, *Mutual Funds, Mutual Conflicts*, Phila. Inquirer, Mar. 9, 1994 ("As absolutist as it seems, abolishing personal trading entirely may be the only approach the investment industry can afford.").

[79] Levitt remarks, *supra* note 78; Robert McGough & Sara Calian, *SEC Focuses on Personal Trades*, Wall St. J., Jan. 13, 1994, at C1, C25 (quoting Kathryn McGrath, former Division director) ("The mutual fund industry 'has a very clean reputation,' she says. But because of the industry's explosive growth, 'there is so much more money being handled in the care of these folks that the standards for watching them need to be raised.'").

[80] *Mutual Funds Need Tighter Rules* (editorial), Bus. Week, Feb. 14, 1994, at 134 ("One way for the mutual-fund industry to retain its squeaky-clean image is to forbid its managers from trading for themselves."); Tom Petruno, *When It Comes to Fund Industry, Public Trust Must Be a Mutual Issue*, L.A. Times, Jan. 12, 1994, at D1, D3 ("If investors begin to doubt that fund managers are much different from the market crooks who paraded through federal courts in the 1980s -- people whose main goal was to enrich themselves, to others' detriment -- the fund industry will lose one of its most important selling points with the small investor.").

by fund managers analyzing particular investments should benefit only fund investors and not the managers themselves.[81]

Opponents of a ban cite a variety of reasons for their view. Some maintain that a ban is simply unnecessary to encourage high ethical standards among investment personnel. The ICI Report argues, for instance, that competitive pressures in the fund industry should induce funds to adopt high standards. According to the Report "[n]o investment management firm will succeed in [today's competitive] environment unless it consistently serves the interests of the customer first."[82] Some commentators opposed to a ban contend that personal investing potentially provides benefits to fund shareholders by sharpening fund managers' skills.[83] Other opponents argue that a ban would place mutual funds at a competitive disadvantage, in terms of hiring and retaining qualified personnel, to other institutional investors, such as employee benefit plans, hedge funds, insurance company separate accounts, and bank trust departments, which do not prohibit personal investing by their investment professionals.[84]

From the Division's perspective, it is relevant to consider whether the Commission's authority under section 17(j) is sufficiently broad to enable it to prohibit the practice. As noted above in Part II.A.1 of this Report, by its terms, section 17(j) does not contemplate a ban on all personal investing. The legislative history of section 17(j) is consistent with the view that the Commission's authority under the section is limited. At no time, in considering the provision that became section 17(j), did Congress indicate a desire to prohibit personal trading. Moreover, in making the recommendation to Congress that ultimately resulted in the enactment of section 17(j), the Commission, as pointed out above, stated expressly that "persons affiliated with investment companies cannot be expected to

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[81] Susan Antilla, *Fund Managers Testing the Rules*, N.Y. Times, Jan. 23, 1994, at F15 (quoting a trustee of a mutual fund, who said that fund managers are "spending time analyzing stocks that aren't benefiting the fund. . . . They can all say 'I do it at home after my kids are in bed,' but, well, give me a break."); Henry Dubroff, *Expect Your Mutual Fund Manager to 'Eat His Own Cooking'*, Denver Post, Jan. 16, 1994, at 1C ("I don't want the people who manage my mutual funds spending a lot of time or making a lot of money on personal deals when they should be watching the funds' money.").

[82] ICI Report, *supra* note 47, at 21.

[83] Robert McGough, *A Primer on Questions Surrounding Personal Trading by Fund Managers*, Wall St. J., Jan. 17, 1994, at C10 (quoting a Fidelity spokeswoman, who said "We strongly believe that allowing our managers to trade individual stocks sharpens their skills, educates them about the markets, and ultimately produces even better performance for our shareholders."); John Durie, *Government Ready to Rein in Funds Biz.*, N.Y. Post, Jan. 12, 1994 ("It is ridiculous to ban fund managers from buying stocks, if for no other reason than personal experience in the game makes for a better manager.").

[84] *See Mutual Satisfaction* (editorial), Wall St. J., May 25, 1994, at A16 ("[A]n outright prohibition on trading . . . would impel more top investment pros to leave the public funds, or else to demand far higher salaried compensation and thus boost management fees for mutual [fund] shareholders."); Richard M. Phillips, Christian E. Plaza, and Mitchell B. Birner, *Personal Trading by Persons Associated with Mutual Fund Advisers: A Time for Re-Evaluation*, The Inv. Law., at 3, 4 (May 1994) ("To . . . prohibit investment company employees from managing their personal portfolios could place the mutual fund industry at an unfair competitive disadvantage with other money managers in competing for qualified personnel."); James M. Pethokoukis, *Controversy Has Yet to Sully Funds' Image*, Investor's Bus. Daily, Mar. 4, 1994 (quoting A. Michael Lipper, president of Lipper Analytical Services) ("And what I think would happen [with a ban on personal trading] is that the good money managers would leave for hedge funds.").

refrain from engaging in securities transactions for their personal accounts."[85] In view of the language and legislative history of section 17(j), the Division believes that the Commission should not prohibit all personal trading by fund insiders unless its authority to do so is clarified and confirmed by Congress. The Commission's Office of the General Counsel concurs with the Division's position.

In the Division's view, whether personal investment activities by fund access persons should be banned depends on an analysis of three related issues: the prevalence of abusive securities transactions by access persons; the potential harm to fund shareholders caused by access persons' personal investment activities; and the likelihood that a ban would curb abusive trading by access persons. The Division has considered each of these issues and has concluded that prohibiting investment by access persons is not warranted at this time.

The evidence the Division has reviewed to date suggests that abusive investing by fund access persons is not prevalent throughout the fund industry. The Division's inspectors, who review personal securities transactions in the normal course of fund examinations, have found few instances of abusive investing by fund access persons.[86] The results of the staff's special examination support the experience of the Division's inspection staff. The data from the special examination shows that a substantial percentage of fund managers did not invest, or invested only infrequently, for their personal accounts.[87] The data also suggests that those managers who invested generally did not engage in transactions that raised potential conflicts of interest with their funds.[88]

The special examination indicates not only that potentially abusive personal securities transactions by fund managers are infrequent, but also that the fund industry seeks to ensure that abusive transactions do not occur. The examination suggests that funds review their codes of ethics regularly and that at least some funds sanction severely employees who violate fund codes. The Division believes that the recent interest shown by Congress and the Commission in the issue of personal investing, the increase in the number of Division examiners currently contemplated,[89] an increase in the frequency of the Division's investment company inspections, and widespread acceptance of the recommendations contained in the ICI Report and this Report should all serve to further minimize abusive investing by fund access persons.

In the absence of compelling evidence that abusive personal investing by fund access persons is widespread throughout the fund industry, the Division believes that a ban on personal investing could be justified only on the basis of a finding that the potential harm to fund shareholders resulting from the practice is so great as to be contrary to the public interest. In the Division's view, such a finding is unwarranted.

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[85] *See supra* note 11 and accompanying text.

[86] As suggested above in Part II.B of this Report, the Division believes that more examinations of funds need to be undertaken to confirm this finding.

[87] *See* Part III.C.5 of this Report.

[88] *See* Parts III.C.6 through III.C.8 of this Report.

[89] The Division currently has 203 investment company examiners, an increase of 50 examiners during fiscal year 1994. The Division's fiscal year 1995 budget contemplates the hiring of another 50 investment company examiners. The Division anticipates requesting an additional 50 examiners in fiscal year 1996.

As suggested by Congress in enacting section 17(j) and by the Commission in adopting rule 17j-1, many personal investments by fund managers raise no public policy concerns.[90] Among the transactions that the Commission itself has cited as not abusive and not contrary to the purposes of section 17(j) are "ones which are: non-volitional on the part of the access person involved in the transaction; only remotely potentially harmful to [the fund managed by the access person] because they would be very unlikely to affect a highly institutional market; or clearly not related economically to the securities to be purchased, sold or held by the fund." The Commission has said that none of these transactions is contrary to the interests of a fund's shareholders because they do not "create the conflict of interest situations to which Section 17(j) was addressed."[91]

The kinds of transactions to which section 17(j) and rule 17j-1 are addressed all share a common characteristic. Each such transaction involves an access person's placing his interests ahead of those of the fund he serves when making personal investment decisions.[92] Because such abusive transactions already are prohibited by a number of existing provisions of the federal securities laws,[93] banning all personal securities transactions by access persons is not necessary. A ban on all forms of personal investing by access persons would not provide fund shareholders with any additional protection from abusive investing than they have now, but could deny access persons the benefits of many legitimate investment opportunities.[94] The Division believes that such a result is not desirable.

In the Division's view, banning personal investing would in all likelihood not curb abusive transactions any more effectively than does the scheme currently contemplated by section 17(j). Fund managers have in the past made personal investments that are prohibited under existing laws. In many, if not most, of those cases the illegal investments were not reported to the managers' employers.[95] It is quite likely that a ban would not, any more

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[90] Because many forms of personal investing are consistent with sound public policy, a ban in all likelihood would need to be subject to numerous exceptions or provide for an exemption procedure. Such exceptions or exemptive procedure would likely result in the Division's receiving a significant number of requests for administrative or interpretive relief, which could strain the Division's resources even further. The Division's compelling need for resources has been discussed with Congress on a number of recent occasions. *E.g.*, Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, Concerning the Investment Company Industry Before the House Subcommittee on Telecommunications and Finance (Aug. 5, 1993) (there is a "dangerous shortfall in the Commission's resources to oversee" the investment company industry and without additional resources "the task [the staff] face[s] may become too great to provide any real measure of deterrence or investor protection").

[91] Release No. 11421, *supra* note 21.

[92] *Id.*

[93] See the discussion in Part II.A.3 of this Report.

[94] Some observers have suggested that fund managers should be allowed to invest only in the funds they manage. The Division believes that such a limitation on fund managers similarly would not afford greater protection to fund shareholders than the existing regulatory scheme. In addition, such a limitation could penalize a manager whose personal financial situation was inconsistent with the investment objectives and policies of the fund he manages.

[95] *E.g.*, *Ostrander*, *supra* note 35. In addition, press accounts regarding the transactions undertaken by the fired Invesco fund manager have noted that his transactions were not reported to his employer. *E.g.*, McGough and Calian, *supra* note 37, at C1.

than current regulation, deter persons who are willing to hide securities transactions from engaging in abusive trading.

The Division believes that, like a total ban, a partial ban on investing by access persons, under which they would be prohibited from holding only securities held by their fund, would not deter wrongdoers any more effectively than current regulations. In addition, such a partial ban could encourage an unscrupulous fund manager to divide investment opportunities between the fund and his personal account.[96]

The Division's decision not to recommend an industry-wide ban on all personal transactions by access persons is not intended to indicate that it would be inappropriate for individual funds to prohibit personal investing by some or all of their personnel. The Division agrees with Chairman Levitt that each fund's board of directors or trustees, in determining the appropriate restrictions to place on personal investing by access persons, should consider whether to ban all personal transactions.[97] In particular, the board should ask fund management for an explanation of the purpose personal investing serves. If fund management and the board are satisfied that personal investing is desirable and not inconsistent with the interests of shareholders, the board should ensure that the fund's code of ethics contains comprehensive safeguards, reporting, and verification procedures.[98]

B. Incorporating the ICI Report's Recommendations into Commission Rules

Many observers have commented favorably on the ICI Report. Chairman Dingell has commended the ICI for its "swift and comprehensive" response and has referred to the Report's recommendations as "tough and far-reaching."[99] Chairman Markey has said that he is "very impressed" with the Report's "forceful and impressive" recommendations.[100] Chairman Levitt has said of the recommendations: "We were pleased with [them.] They go a long way toward responding to our concerns."[101] Even many industry participants who could be subject to more stringent investment restrictions praised the Report's recommendations.[102] Like these commentators, the Division commends the ICI special advisory group for taking a decisive initiative in addressing the conflicts of interest that can result from personal investing by fund personnel.

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[96] To the extent that a fund manager withholds opportunities from the fund to benefit himself, he would violate certain provisions of the federal securities laws. *See, e.g.*, *SEC v. Embry*, Litigation Release No. 13777 (Sept. 9, 1993).

[97] Levitt remarks, *supra* note 78, at 6.

[98] *Id.*

[99] Dingell letter, *supra* note 75.

[100] Brett D. Fromson, *Mutual Fund Industry Panel Would Curb Personal Trades*, Wash. Post, May 10, 1994, at C5; Susan Antilla, *Raining on Fund Managers' Parade*, N.Y. Times, May 8, 1994, at F13.

[101] Remarks by Arthur Levitt, Chairman, U.S. Securities and Exchange Commission, at the Investment Company Institute Annual Conference, Washington, D.C. (May 18, 1994), at 1.

[102] Sara Calian, *Few Funds Gain in Past Three Months*, Wall St. J., May 10, 1994, at C1, C27 (quoting Shelby Davis, a portfolio manager and president of the Selected/Venture fund group, and John C. Bogle, chairman of the Vanguard Group).

In light of its assessment of the ICI Report, the Division believes it appropriate to consider whether the Commission should adopt some or all of the Report's recommendations as rules under the 1940 Act or other federal securities laws. Some commentators specifically have cited standards such as blackout periods, pre-clearance, and prohibitions on short-term trading as being particularly appropriate candidates for Commission rulemaking.[103]

As noted above in Part II.E of this Report, the ICI Report does not conclude that any of its recommendations should be adopted as Commission rules. Although certain of the Division's recommendations mirror, or are substantially similar to, certain of the Report's recommendations, the Division is not recommending that any of the substantive restrictions on personal investing activities recommended by the Report be implemented as Commission rules.[104] While the Division strongly encourages funds to adopt the ICI Report's recommendations, it believes that the Commission's rationale for not mandating uniform standards of conduct governing personal investing was correct in 1980 and is even more compelling today.

In determining not to mandate uniform standards when it adopted rule 17j-1, the Commission emphasized the need for each fund to have the flexibility to design specific means to prevent abusive investing by access persons, with restrictions and procedures suited to the fund's particular size, investment objectives, structure, and operations. The Commission said at the time that:

> [t]he broad language of the Rule is intended to permit entities to consider transactions by access persons in the context of their particular business operations when adopting their individual codes of ethics.[105]

The Commission added that it:

> has determined . . . to let individual entities take fully into account their own unique circumstances in designing their codes of ethics prescribing standards of conduct which effectuate the purposes of the Rule. . . . The Commission believes the current approach is more desirable [than mandating or suggesting particular standards] because it gives maximum flexibility to the entities which must design the codes of ethics.[106]

In affording funds the flexibility to design their own codes of ethics, the Commission acknowledged, as it and Congress have recognized consistently over the past 30 years, that no one set of standards is appropriate for every fund.[107] The Division believes that this

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[103] Phillips, Plaza, and Birner, *supra* note 84.

[104] In the Division's view, the Commission's authority under section 17(j) to adopt certain of the ICI Report's recommendations is unclear. The Commission's Office of the General Counsel concurs in this view.

[105] Release No. 11421, *supra* note 21.

[106] *Id.*

[107] *See* Part II.A of this Report.

principle continues to be valid today.[108] Funds need to have the ability to tailor codes of ethics to their individual characteristics. Pre-clearing all personal securities transactions may not be necessary, for example, for a fund that distributes to its employees a list of restricted securities on a daily basis. A fund whose investment policies contemplate significant portfolio turnover will likely need more restrictions to address ethical concerns than a fund whose investment policies contemplate only limited trading activities. A fund that invests primarily in securities of large capitalization companies traded over major U.S. exchanges may not need as many restrictions in a code of ethics as a fund that invests in thinly traded securities of smaller capitalization companies. Finally, a fund that seeks to mirror the performance of a particular index may not require the same restrictions as a fund that invests primarily in a particular industry sector or in the securities of companies located in a foreign country.

In determining not to provide for mandatory code of ethics provisions in rule 17j-1, the Commission spoke not only of the need for flexibility in developing codes of ethics, but also of the "difficulties of interpretation and administration" it concluded were likely to result if it adopted uniform code standards.[109] The Division believes that, in light of the diversity of fund types that now characterizes the fund industry, the Commission's adoption of uniform code of ethics provisions would in fact lead to countless requests for interpretations of, or exemptive relief from, provisions that did not fit a particular fund's specific circumstances. Such a result could only serve to burden further the Division's limited resources, without necessarily providing increased protection to fund shareholders.

Although, for the reasons described above, the Division does not support amending rule 17j-1 to require all funds to adopt uniform code of ethics provisions, the Division believes that the management and board of directors or trustees of each fund should specifically consider the recommendations in the ICI Report. Moreover, the Division would expect all funds to adopt the Report's recommendations, in whole or substantial part, absent special circumstances.

The ICI expects that 85-90% of the mutual fund industry will revise their codes of ethics to meet the standards of conduct reflected in the ICI Report's recommendations.[110] The Division will request a report from the ICI within the next six months describing, among other things, the number of ICI members that have adopted the recommendations and any interpretive, administrative, or other problems ICI members have experienced in implementing the recommendations. On the basis of that report, the Division may reconsider the issue of amending rule 17j-1 to provide for uniform code of ethics standards.

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[108] The need for flexibility may be even more compelling today than it was in 1980 when rule 17j-1 was adopted, in light of the proliferation of different types of funds. Lipper Analytical Services, for example, currently tracks 56 different categories of non-money market mutual funds.

[109] Release No. 10162, *supra* note 19.

[110] *See* Fromson, *supra* note 100, at C5.

V. RECOMMENDATIONS

Although the Division believes that fundamental changes in the regulatory scheme governing personal investing by fund access persons are not warranted at this time, the Division believes that the regulatory scheme can and should be improved. In seeking that result, the Division has developed six recommendations.

The Division's recommendations are designed to further protect fund shareholders by making available to the public additional information about fund policies on personal investment; enhancing the oversight of personal investment policies by fund boards of directors or trustees; making it easier for both funds and the Commission's staff to monitor the personal transactions of fund personnel; and clarifying the scope of prohibited activities by fund personnel. The specific recommendations of the Division are described in detail below.

Recommendation 1: DISCLOSURE OF PERSONAL INVESTING POLICIES
The Division recommends that funds be required to publicly disclose their policies and procedures regarding personal investing by fund personnel.

Recent press accounts, as noted above, have suggested that fund shareholders may not fully understand the potential conflicts of interest raised when fund personnel invest for their personal accounts[111] and have reported that many fund groups are unwilling to make the terms of their codes of ethics available to the public.[112] Correspondence received by the Division from fund shareholders has confirmed that investors want more information about funds' personal investment policies. The Division believes that investors have a right to know whether and to what extent fund personnel are permitted to invest for their own accounts. The Division, therefore, recommends that each fund be required to disclose to existing and prospective shareholders its policies regarding personal investing.

The Division contemplates that its recommendation would be implemented by the Commission requiring each fund to disclose briefly in its prospectus its policies with respect to personal investing by its personnel and the manner in which an investor can obtain a copy of the fund's code of ethics.[113] In addition, the Division anticipates recommending that the Commission require each fund to attach as an exhibit to its registration statement under the 1940 Act a copy of its code of ethics as currently in effect. The latter requirement would be designed to make the terms and conditions of codes of ethics available not only to fund shareholders, but also to the press and other media, which could analyze and compare codes for the benefit of the general public.

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[111] *See supra* note 44 and accompanying text.

[112] *See supra* note 45 and accompanying text.

[113] If, as the ICI expects, the recommendations included in the ICI Report become the industry norm, the Division would anticipate proposing that the Commission expand this disclosure requirement to include a discussion by the fund comparing or contrasting the terms of its code of ethics to the recommendations. *See supra* text accompanying note 110.

Recommendation 2: ENHANCED BOARD REVIEW
The Division recommends that rule 17j-1 be amended to require that a fund's board of directors or trustees annually review all codes of ethics applicable to the fund.

Under section 17(j) and rule 17j-1, the board of directors or trustees of a fund, particularly the fund's directors or trustees who are not interested persons of the fund, have a significant oversight role with respect to the personal investment activities of fund personnel. Consistent with the rule, the board is responsible for ensuring that the fund establishes a code of ethics that meets the requirements of the rule, and for monitoring the ongoing operation of the code. As suggested above in Part IV.A of this Report,[114] the board should determine as an initial matter whether personal investing is consistent with the interests of the fund's shareholders and should be permitted. The board should, among other things, also examine whether both the fund and its adviser (and any subadvisers) have adopted appropriate measures designed to prevent and detect abusive investment practices and whether they have instituted effective compliance procedures.[115] If any violations of the policies applicable to the fund occur, the board should consider whether the individual engaged in the improper conduct received an appropriate sanction.[116]

To enhance board oversight of personal investment activities of fund access persons, the Division recommends that rule 17j-1 be amended to require each fund's board to review, at least annually, the fund's code of ethics to determine whether any changes are appropriate in light of particular violations or changing circumstances generally. Among the information the Division believes should be provided to a fund's board to enable it to evaluate the fund's code of ethics in a meaningful way is a copy of the fund's existing code, a description of any code violations and any significant remedial actions taken in response, and recommendations (if any) for changes to the code. The Division notes that this recommendation is similar to a recommendation in the ICI Report.

Recommendation 3: DISCLOSURE OF PRE-EMPLOYMENT HOLDINGS
The Division recommends that rule 17j-1 be amended to require each access person of a fund to disclose his personal securities holdings at the time at which the access person is first employed by the fund or its investment adviser.

A fund cannot effectively monitor the potential conflicts of interest arising when its access persons invest for their own accounts unless fund management knows the identity of all securities held by those persons. When examining the records of the 30 fund groups for

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[114] *See supra* text accompanying notes 97-98.

[115] Levitt remarks, *supra* note 78; Phillips, Plaza, and Birner, *supra* note 84, at 8. Many fund boards appear to be giving increasing attention to personal trading matters as a result of the Commission's recent focus on this area. Phillips, Plaza, and Birner, at 8.

[116] The Division believes that the board of a fund that is part of a fund group also has the responsibility of inquiring of fund management whether appropriate policies have been adopted with respect to the group to ensure that investment personnel of one fund in the group are not able to benefit personally as a result of investments made or intended to be made by another fund in the group. In the Division's view, this obligation is implicit in subparagraph (a) of rule 17j-1, which prohibits fraudulent personal trading by all employees of an investment adviser, including those employees whose job responsibilities are not related directly to a particular fund.

purposes of the special examination, the Division's inspection staff found that some of the 30 fund groups did not obtain information about the securities held by new employees.[117]

The Division believes that potential conflicts of interest can arise whenever an access person holds the same securities as his fund, regardless of when the access person acquired the securities.[118] As currently written, however, rule 17j-1 does not explicitly require access persons to report their existing personal securities holdings at the time they commence employment with a fund or an adviser.[119] The Division therefore recommends that rule 17j-1 be amended to require access persons to disclose their personal securities holdings upon becoming employed by the fund or its adviser. The Division believes that implementation of this recommendation would improve a fund's ability to monitor potential conflicts of interest between the fund and its access persons, and reduce the potential for abusive investing by those persons.

<u>Recommendation 4</u>: <u>NOTIFICATION OF BROKERAGE ACTIVITY</u>
The Division recommends that the NASD be asked to consider adopting a rule requiring its members (a) to notify a fund or investment adviser whenever an employee opens an account with the member, and (b) upon request of the fund or adviser, to transmit duplicate copies of the employee's trade confirmations and account statements.

The Division believes that, if the information contemplated by this recommendation was provided directly to funds and their advisers, it would serve as an independent verification of information reported by fund investment personnel to their employers, thus assisting funds and their advisers in monitoring their employees' personal investment activities. The proposed rule would mirror an existing NASD rule that requires member broker-dealers to take similar action with respect to accounts opened and maintained by employees of other broker-dealers.[120]

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[117] Several fund groups had difficulty responding to the staff's request to identify securities purchased by a fund that were, at the time, owned by the fund's manager. To respond, several fund groups had to obtain information from their managers about the managers' holdings at the time of their employment by the groups. Two fund groups could not obtain this information and did not respond to this particular request. *See supra* note 74.

[118] The Commission itself has said that a "situation which would appear to present a conflict of interest of the type of which Section 17(j) is addressed might occur where access persons already own a particular security and through their position of influence over the investment company attempt to cause the investment company to purchase, sell or hold the same security." Release No. 11421, *supra* note 21. Several examples illustrate the conflict of interest presented by an access person's pre-employment holdings. A manager who owns a stock (acquired before his association with a fund) whose price is declining may be tempted to cause the fund to purchase the stock in an effort to stabilize or increase its price. A manager who received warrants to purchase a stock at a fixed price as part of an IPO in which he participated before becoming employed by a fund or its adviser could increase his personal profit by causing the fund to purchase the underlying stock shortly before he exercises the warrants. Finally, any access person who acquired a stock before his association with a fund, and who learns that the fund is considering selling a large block of the stock, may be tempted to sell his personal holdings before the fund's transaction causes the stock's price to decline.

[119] The rule's reporting provisions simply require fund access persons to file reports detailing information about personal investments made during the preceding calendar quarter.

[120] NASD Rules of Fair Practice § 28(b).

Recommendation 5: BAN ON PARTICIPATING IN "HOT ISSUE" PUBLIC OFFERINGS
The Division recommends that the NASD be asked to consider prohibiting the purchase by certain fund access persons of hot issue securities.

Chairman Levitt, as well as certain commentators, have expressed concern that participation by access persons in IPOs, especially "hot issue" IPOs,[121] creates the potential for troublesome conflicts of interest.[122] Because hot issues are expected to increase in value, broker-dealers could offer them as an incentive to induce fund personnel to do business with them. The purchase of a hot issue by fund personnel, therefore, raises an appearance of impropriety. In addition, conflicts of interest can result when access persons compete with their funds for the same hot issues.

The ICI Report seeks to address potential abuses associated with IPOs by recommending that funds prohibit their access persons from acquiring any securities in an IPO. The Division believes that the Commission's authority under section 17(j) may not be sufficiently broad to adopt such a limitation.[123]

In an effort to address the issue of IPO purchases by fund access persons, the Division recommends that the NASD undertake a review of the application to fund personnel of its Free-Riding and Withholding Interpretation (the "Free-Riding Rules") under its Rules of Fair Practice.[124] In particular, the Division intends to ask the NASD to examine its Free-Riding Rules to consider whether the existing ban on sales of hot issues to broker-dealer employees should be extended to personnel of investment companies, investment advisory firms, banks, savings and loans, and insurance companies who have authority to direct business to NASD members.[125] Such a change would effectively prohibit certain investment company and investment advisory personnel from participating in hot issue public offerings.

Recommendation 6: AMENDMENT OF SECTION 17(j)
The Division recommends that Congress amend section 17(j) to cover purchases and sales by a fund access person of property other than securities and to clarify that the section is violated by abusive personal trading in securities and other instruments related in value to the fund's portfolio securities.

The Commission's existing rulemaking authority under section 17(j) to define and proscribe fraud is limited to transactions involving securities. Increasingly, funds are

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[121] The NASD defines "hot issue" securities in its Free-Riding and Withholding Interpretation under its Rules of Fair Practice to be "securities of a public offering which trade at a premium in the secondary market whenever such secondary market begins."

[122] Levitt remarks, *supra* notes 78 and 101; ICI Report, *supra* note 47, at 32-33.

[123] The Commission's Office of the General Counsel shares this view.

[124] The Free-Riding Rules prohibit NASD broker-dealers from selling hot issue securities to, among others, any employee of a broker-dealer. The Free-Riding Rules, however, currently permit sales of hot issues to advisory personnel of investment companies, investment advisory firms, banks, savings and loans, and insurance companies if, among other things, the NASD member can demonstrate that the sales are consistent with a person's usual investment practice and are insubstantial in amount.

[125] Because bank, savings and loan, and insurance company personnel who make investment decisions are subject to the same conflicts of interest as employees of investment companies and investment advisers, the Division believes that any action taken by the NASD should apply equally to all of these groups.

engaging in transactions involving instruments other than securities, such as futures and commodities.[126] The Division believes that the types of abusive conduct to which section 17(j) was addressed can occur with respect to financial instruments that are not securities as that term is defined in the federal securities laws.[127] Thus, the Division recommends that Congress amend section 17(j) to cover purchases and sales by fund access persons of property other than securities.[128]

The Division recommends that, if Congress determines to amend section 17(j) in any manner, Congress should at the same time confirm the section's applicability to transactions by a fund's access persons involving securities and other instruments related to, but not the same as, securities held or to be acquired by the fund.[129] Although Congress appears to have intended section 17(j) to cover activities involving related securities,[130] and the Commission has taken the same position with respect to rule 17j-1,[131] the language of these provisions, as currently drafted, could be interpreted otherwise.

VI. CONCLUSION

Public trust is the foundation underlying the fund industry's recent success. That trust is threatened when fund personnel take advantage of their positions to benefit themselves. Over the past seven months, the Division has examined the personal investment transactions of over six hundred fund managers and compared those transactions to the portfolio transactions of the more than one thousand funds they manage.

The data the Division reviewed indicates that fund managers generally have not engaged in extensive investing for their personal accounts. When engaging in personal securities transactions, fund managers appear to avoid potential conflict of interest situations. Nevertheless, a small number of managers, concentrated within a few fund groups, have actively invested for their personal accounts, in some cases buying or selling securities ahead of their funds or other funds in the complex. The Division currently is examining the personal transactions made by those managers to determine whether they were improper. The Division also is examining the compliance programs of these fund groups to determine whether they exercised adequate oversight over the personal investment activities of their

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[126] *E.g.*, Steven T. Goldberg, *Why Your Bond Fund Got Clobbered*, Kiplinger's Personal Finance Magazine, Sept. 1994; *Amid Fund Losses, SEC Examines Derivatives Limits*, Wall St. J., Sept. 8, 1994, at A20.

[127] The recent *Kemper* case, described above in Part II.C, for example, involved the alleged misallocation of financial futures contracts and not securities.

[128] If Congress amends section 17(j) in accordance with this recommendation, the Division will recommend that the Commission amend the reporting requirements of rule 17j-1 to include property other than securities.

[129] Two securities would be related if, for example, one security is convertible into the other, or gives its holder the right to purchase the other security.

[130] House Report, *supra* note 15, at 28; Senate Report, *supra* note 15, at 28-29.

[131] *See* Release No. 10162, *supra* note 19.

managers. If the examinations indicate abusive conduct or materially deficient compliance procedures, the Division will refer matters to the Division of Enforcement for further action.

The Commission's staff will continue to aggressively investigate and pursue enforcement actions against any fund insiders whose trading activities place their personal interests ahead of their funds'. The Division believes that aggressive inspection and enforcement programs are the most effective deterrent to abusive trading. Inspections and enforcement actions will continue to be effective, however, only if sufficient resources are allocated to those programs.

The Division has concluded that the advantages of banning personal securities transactions, or mandating uniform standards to restrict such transactions, are outweighed by the disadvantages. The Division, however, is recommending changes to the existing regulatory scheme that it believes would enhance investor protection while preserving the flexibility that Congress and the Commission have considered important over the past thirty years. The Division believes that its recommendations, together with widespread industry acceptance of the recommendations described in the ICI Report, will enhance the ethical standards of the industry, thereby benefiting all fund shareholders.

The Division will continue to monitor whether the existing provisions of the federal securities laws are adequate to protect the interests of investors, and whether fund boards of directors or trustees are scrutinizing personal investment policies and activities. As part of its monitoring, the Division will request a report from the ICI within six months describing the industry's efforts to implement the ICI Report's recommendations, and will assess, at that time, the extent to which funds are adhering to those recommendations. If, in the future, the Division deems it necessary or appropriate in the public interest, the Division will recommend that the Commission propose rule amendments or seek additional legislation to impose stricter and more uniform standards on the fund industry.

Exhibit A

February __, 1994

Mr./Ms. xxxxxxx
XYZ Management, Inc.
[ADDRESS]

Re: In the Matter of Certain Trading by Portfolio Managers (MHO-4568)

Dear Mr./Ms. xxxxxxx:

The Divisions of Investment Management and Enforcement are currently examining issues associated with personal trading by investment company portfolio managers. 1/ As part of that examination, we request that XYZ Management, Inc. ("XYZ") provide the following documents and information as applicable to calendar year 1993 (the "reporting period") with respect to each fund 2/ for which XYZ or any of its affiliates acts as investment adviser and/or sub-adviser 3/ (the "XYZ Funds"):

1. General Information

(a) Please list each XYZ Fund by name and give the fund's investment objective as characterized by Lipper Analytical Services, Inc. Identify each fund's portfolio manager(s) and indicate, for each manager, the dates he or she started and (if applicable) stopped rendering advisory services to the fund (do not limit your response to the reporting period).

(b) For each portfolio manager identified in subparagraph (a) above: (i) name the manager's employer, (ii) state whether the employer is affiliated with the XYZ funds other than as investment adviser, (iii) specify the dates the manager was employed by the employer; and (iv) provide the names of any company for whom the manager served during the reporting period as an officer or director, if any securities issued by that company were held by any XYZ fund during the reporting period.

(c) For each XYZ fund that is not a money market fund within the meaning of rule 2a-7 under the Investment Company Act of 1940 ("Investment Company Act"), please state

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1/ For purposes of this letter, an investment company's "portfolio manager" is the person (or persons) primarily responsible for the day-to-day management of the company's portfolio. See paragraph (c) of Item 5 in Form N-1A.

2/ For purposes of this letter, a "fund" is any management investment company registered under the Investment Company Act of 1940, whether open-end or closed-end. Each series of a registered open-end company should be deemed a separate fund for purposes of this letter.

3/ To the extent any XYZ Fund uses the services of an investment adviser or sub-adviser not affiliated with XYZ, you should provide information about that adviser or sub-adviser in response to the following questions.

Mr./Ms. xxxxxxx
XYZ Management, Inc.
Page 2

(i) the total number of portfolio transactions (purchases and sales of securities 4/) effected during the reporting period, (ii) the dollar value of the securities purchased or sold, whichever is greater, and (iii) the aggregate net assets at the beginning and end of the reporting period.

2. Code of Ethics

For each XYZ fund, please submit a copy of any code of ethics ("Code") required by paragraph (b)(1) of rule 17j-1 under the Investment Company Act that was in effect during the reporting period. If the same Code governs more than one XYZ fund, multiple copies need not be submitted, but please indicate which XYZ funds were governed by that Code. If a Code was amended during the reporting period, please submit a copy of each version that was in effect during the period, and mark each version to show when it was effective and how it was amended. In addition, please submit any rules, guidelines, procedures, or policies (collectively, "Policies"), including but not limited to the Policies required to be implemented by section 204A of the Investment Advisers Act of 1940, regarding personal trading activity by XYZ access persons 5/ that were in effect during the reporting period but were not part of a fund's Code. If any Policies have not formally been reduced to writing, please submit a written description of those Policies.

Please attach to each Code submitted in response to this request a completed questionnaire substantially in the form attached as Exhibit A to this letter.

3. Violations

For each violation of XYZ's Code(s) or Policies that occurred within the reporting period please provide: (i) the name of the violator, (ii) the date of the violation, (iii) a description of the violation, (iv) the name and job title of the person responsible for discovering and/or investigating the violation, (v) whether any disciplinary action was taken as a result of the violation, and (vi) whether any steps were taken to prevent a recurrence. If you answered affirmatively to either (v) or (vi) above, provide detailed explanations.

4. Personal Trading Activity by Portfolio Managers

(a) Did any portfolio manager, during the reporting period, purchase (or sell), for his or her own account, 6/ any security that was purchased (or sold) by any XYZ fund (not

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4/ Unless otherwise noted, for purposes of this letter, the term "securities" means: equity and debt securities (except as set forth below); options on and warrants to purchase equity or debt securities; and shares of closed-end investment companies. The term does not include: money market securities; securities issued by the United States government; or shares of open-end investment companies or unit investment trusts.

5/ The term "access persons" is defined in paragraph (e)(1) of rule 17j-1 under the Investment Company Act.

6/ For purposes of this letter, the purchase or sale of a security for a portfolio manager's own account includes any transactions in a security in which the portfolio manager has or is acquiring a direct or indirect beneficial interest. See paragraph (c)(1) of rule 17j-1.

Mr./Ms. xxxxxxx
XYZ Management, Inc.
Page 3

including any index fund) within the next thirty days? 7/ If so, provide the information requested in paragraph (e) below.

(b) Did any portfolio manager, during the reporting period, purchase (or sell), for his or her own account, any security whose value or return was related, in whole or in part, to the value or return of a different security that was purchased (or sold) by any XYZ fund (not including any index fund) within the next thirty days? 8/ If so, provide the information requested in paragraph (e) below.

(c) For purposes of subparagraphs (a) and (b) above, you should (i) only report instances where a portfolio manager *purchased* a security that subsequently was *purchased* by a fund, or where a portfolio manager *sold* a security that subsequently was *sold* by a fund; and (ii) exclude a portfolio manager's purchase or short sale of a security if he or she closed out the position in its entirety prior to any purchase or sale of the same, or a related, security by an XYZ fund.

(d) Did any portfolio manager, during the reporting period, purchase, for his or her own account, any security that was sold during the preceding thirty days by an XYZ fund managed by the portfolio manager? If so, provide the information requested in paragraph (e) below.

(e) For each set of transactions identified in response to subparagraphs (a), (b), and (d) above, name the portfolio manager and the fund that engaged in the transactions, and provide the following information about the transaction effected by each party: (i) a description of the security traded, (ii) the type of transaction (i.e., purchase or sale (specify if short sale)), (iii) the trade date, (iv) the price per unit of the security traded, the quantity traded, and the total amount of the transaction, and (v) the name of the broker/dealer through whom the trade was effected.

(f) Please provide a summary sheet that specifies, for each portfolio manager, and for all portfolio managers as a group: (i) the number of personal trades involving securities, (ii) the number of trades identified in response to each of subparagraphs (a), (b), and (d) above, and (iii) the number of trades identified in response to subparagraphs (a) and (b) above that involve a set of trades by a portfolio manager and the particular XYZ fund(s) he or she manages.

7/ Thirty days may be longer or shorter than the trading restriction period, if any, specified in a particular fund's Code. The selection of the thirty-day period should not be construed as an indication of the Commission staff's views as to an appropriate restriction period for a code of ethics adopted pursuant to rule 17j-1 or for any other purpose.

8/ For example, options or warrants to purchase common stock, and convertible debt and convertible preferred stock, should be considered "related to" the underlying common stock for purposes of Item 4. Preferred stock and debt issued by a particular company that are not convertible should not be considered related to the company's common stock for purposes of Item 4. Different classes of a company's common stock should be considered to be related securities unless the value or return of one class unequivocally is unrelated to the value or return of the other class.

5. Trading Activity by XYZ Funds

(a) Did any XYZ fund, during the reporting period, purchase any equity security that at the time was beneficially owned by an XYZ portfolio manager, regardless of when the portfolio manager acquired the security? 9/ If so, for each transaction identified, name the fund that purchased, and the portfolio manager(s) who held, the security, and provide the following information about the transaction effected by each party: (i) a description of the security acquired, (ii) the trade date, (iii) the purchase price per share, (iv) the number of shares purchased, (v) the total value of the shares purchased, and (vi) whether the security was purchased as part of an initial public offering.

(b) Please provide a summary sheet that specifies, for each XYZ fund: (i) the total number of purchase transactions involving equity securities effected during the reporting period, and (ii) the number of purchase transactions that involved an equity security that at the time of purchase was owned by any XYZ portfolio manager.

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The information requested in Items 1(a)-(c), 4(e)-(f), and 5(a)-(b) should be submitted in spreadsheet form on the formatted diskette enclosed with this letter. We have also enclosed a short set of general instructions to assist you in inputting the requested data into the spreadsheet. A more detailed set of instructions will follow.

This request for documents and information should not be construed as an adverse reflection upon any person, entity, or security or as an indication by the Commission or its staff that any violation of law has occurred. Enclosed is a copy of Commission Form 1661, which discusses how the Commission can use the information you provide, and other important matters.

Please respond by March 31, 1994. The information requested, and any questions about the spreadsheet format, should be directed to Greg Jaffray, Financial Analyst, Division of Investment Management, Mail Stop 10-6, 450 Fifth Street, NW, Washington DC 20549, phone number (202) 272-3014. All other inquiries should be directed to the Division of Investment Management's Office of Chief Counsel, at (202) 272-2072.

Barry P. Barbash
Director, Division of Investment Management

William R. McLucas
Director, Division of Enforcement

9/ For purposes of this item, include all equity securities issued by the same issuer unless the value or return of one security unequivocally is unrelated to the value or return of the other security.

March __, 1994

VIA REGISTERED MAIL

Mr./Ms. xxxxxxx
XYZ Management, Inc.
[ADDRESS]

Re: In the Matter of Certain Trading by Portfolio Managers (MHO-4568)

Dear Mr./Ms. xxxxxxx:

This letter supplements our letter to you dated February _, 1994 (the "February Letter"), in which we requested information about the personal trading activities of certain XYZ Management, Inc. ("XYZ") personnel. We received several inquiries seeking clarification of the February Letter. In response to these inquiries, we are amending the February Letter as indicated below.

All information requested in the February Letter should be submitted to the Commission's staff in the manner prescribed in the February Letter unless otherwise specifically indicated in this letter. Unless otherwise indicated, all terms used in this letter have the same meaning as in the February Letter.

1. Items 1, 4, and 5 of the February Letter require XYZ to name the portfolio managers of the XYZ Funds. Item 3 (see paragraph 2 below) requires XYZ to identify individuals who have committed certain violations of XYZ's Code(s) or Policies. In responding to these Items, numerical or letter codes, rather than names, may be used to identify particular individuals. Only one code, however, may be used for each individual. In addition, XYZ must make available to the Commission's staff, upon request, the name of the individual corresponding to each code.

2. Item 3 of the February Letter is superseded by the following request:

> Describe generally how XYZ's Code(s) or Policies are implemented, administered, and enforced. Identify all instances during the reporting period when (i) XYZ took significant remedial action against any individual for a violation of XYZ's Code(s) or Policies, or (ii) an individual resigned from his or her position to avoid significant remedial action by XYZ. For purposes of this Item, significant remedial action includes any action that has a pecuniary effect on an individual, such as firing, suspending, or demoting the person, or requiring the reversal of a trade or the disgorgement of profits. Significant remedial action also includes any non-pecuniary action that might affect the person's promotion opportunities, such as reassignment, suspension with pay, or formal censure. For each significant remedial action taken, identify the person who violated XYZ's Code(s) or Policies, state the person's job title/position, and describe the violation, how it was discovered, the disciplinary action taken against the person, and the steps taken, if any, to prevent a recurrence of the violation.

Mr./Ms. xxxxxxx
XYZ Management, Inc.
March __, 1994
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3. Item 4 of the February Letter is amended as follows:

(a) A ten (10) day period should be substituted for the thirty (30) day period provided for in paragraphs (a), (b), and (d) of Item 4.

(b) Except as set forth in the last sentence of this paragraph, transactions by XYZ Funds or portfolio managers in any equity or debt security issued by the companies listed in Attachment A to this letter do not have to be reported. 1/ This exclusion does not extend to transactions by XYZ Funds or managers in options, warrants, and other securities whose value or return was related, in whole or in part, to the value or return of a security issued by one of the companies listed in Attachment A. Moreover, transactions by XYZ Funds in securities issued by companies listed in Attachment A must be reported if they occurred ten (10) days or less after a transaction by an XYZ portfolio manager in an option, warrant, or other security whose value or return was related, in whole or in part, to the value or return of a security issued by one of those companies.

(c) In responding to paragraph (e) of Item 4, indicate whether the portfolio manager's trade was pre-cleared or otherwise pre-approved. To answer this question, add a column (Column S) to Worksheet 3 and enter in this column: "Yes" if the trade was pre-cleared; "No" if the fund had a pre-clearance procedure and the trade was not pre-cleared; and "N/A" if the fund had no pre-clearance procedure.

4. Item 5 of the February Letter should incorporate the changes indicated below:

(a) The first sentence of paragraph (a) of Item 5 is amended as follows: "Did any XYZ Fund, during the reporting period, purchase any equity security that at the time of purchase also was beneficially owned by ~~an XYZ~~ its portfolio manager, regardless of when the portfolio manager acquired the security?" Part (ii) of paragraph (b) of Item 5 is amended to reflect the change in paragraph (a), so that the summary sheet specifies, for each XYZ Fund, "the number of purchase transactions that involved an equity security that at the time of purchase also was owned by ~~any XYZ~~ the fund's portfolio manager."

(b) Part (vi) of paragraph (a) of Item 5 is amended to add the underlined material: "(vi) whether the security was purchased as part of a private placement (PP) or an initial public offering (IPO)." In Columns H and N of Worksheet 4, enter "PP," "IPO," or "N/A," as appropriate.

5. In addition to responding to all Items in the February Letter as amended by this letter, please respond to the following new Item 6:

(a) Describe XYZ's policies, if any, regarding cross-trading, i.e., do the same prohibitions that apply to personal trading by a portfolio manager in securities that are held by or under consideration for purchase or sale by the fund(s) served by the manager apply to securities that are held by or under consideration for purchase

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1/ The stocks listed in Attachment A represent the 100 stocks that comprised the Standard & Poor's 100 Composite Index as of June 30, 1993. Since the index may have changed during the course of the year, we have used the midpoint as a representative date.

or sale by other funds or other clients advised by XYZ or any of its affiliates? If XYZ has no policies regarding cross-trading, explain why not.

(b) Describe XYZ's policies, if any, with respect to its portfolio managers' purchase of securities in offerings not registered under the Securities Act of 1933 (including, for example, private placements) and purchase of securities when initially offered to the public.

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In light of the changes and additional information requested in this letter, we have determined to extend the date by which all information must be submitted to the Commission's staff from March 31, 1994 to April 15, 1994. If you have any questions about inputting data into the worksheets (provided in diskette form with the February Letter), including how to add a column to Worksheet 3 (as requested in paragraph 3(c) above), you should call Greg Jaffray of the Division of Investment Management at (202) 272-3014. All other inquiries should be directed to the Division of Investment Management's Office of Chief Counsel, at (202) 272-2072.

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Barry P. Barbash
Director, Division of Investment Management

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William R. McLucas
Director, Division of Enforcement

Exhibit B

STATISTICAL SUMMARY OF THE CODES OF ETHICS SUBMITTED BY THE 30 FUND GROUPS 1/

Pre-clearance

- 19 fund groups require certain employees to pre-clear all personal securities trades. 2/

- 4 fund groups require certain employees to pre-clear defined categories of transactions, such as those involving options and futures, or securities on a "restricted" list.

Prohibition on Investing in Securities While Fund is Investing

- 21 fund groups expressly prohibit certain employees from purchasing or selling any securities that they know are being considered for purchase or sale, or are being purchased or sold, by the fund.

Blackout Period

- 16 fund groups impose a "blackout period" during which certain employees are prohibited from investing in securities for a specified time before and/or after the fund has purchased or sold the same securities, or the fund's adviser has issued a research report covering the securities. The blackout periods range from 15 days before to 30 days after the securities are bought or sold by a fund in the group or appear on a restricted list.

Initial Public Offerings/ Hot Issues

- 5 fund groups restrict or prohibit certain employees from purchasing securities in any IPO.

- 9 fund groups restrict or prohibit certain employees from purchasing "hot issues," including hot issue IPOs.

Private Placements

- 5 fund groups restrict or prohibit certain employees from purchasing securities through a private placement.

1/ The Commission staff reviewed the codes of ethics in effect for the 30 fund groups during calendar year 1993. For purposes of this Exhibit, the staff examined 31 sets of codes of ethics, rather than 30. Because one of the fund groups consisted of two fund groups that had recently merged, the two groups' operations had not been integrated, and each employed different codes of ethics, the staff treated each as a separate fund group for purposes of this Exhibit only. In addition, the statistics cited sometimes reflect (when such information was provided) restrictions and procedures that went into effect in 1994, after the reporting period for which the staff requested information.

2/ For purposes of this Exhibit, the term "securities" is defined the same as it is in rule 17j-1.

- 2 fund groups require pre-clearance for private placement securities but not other purchases of securities.

Scope of Restrictions

The staff asked each fund group to describe whether the same restrictions that apply to personal investment transactions by a portfolio manager with respect to securities that are held by or under consideration for purchase by the manager's fund also apply with respect to securities that are held by or under consideration for purchase by other funds or other clients advised by the manager's employer.

- 24 fund groups answered yes.

Short-Term Trading Ban

- 4 fund groups require certain employees to hold securities for a prescribed minimum period of time, whether or not the securities are held by a fund in the fund group.

Disclosure of Holdings at Commencement of Employment

- Only one fund group indicated that it requires new employees to disclose their securities holdings upon commencement of their employment.

Periodic Reports

- 18 fund groups require employees to report their securities transactions contemporaneously, either in addition to, or in lieu of, filing the quarterly reports required under rule 17j-1.

Exhibit C

DESCRIPTION OF CODES OF ETHICS VIOLATIONS

The staff asked each of the 30 fund groups subject to the special examination to identify all instances in 1993 when (a) it took significant remedial action against any individual for a violation of any applicable code of ethics, or (b) an individual resigned from his position to avoid significant remedial action by the fund group. 1/ Five fund groups (referred to below as Fund Groups #1 through 5) reported code violations by twelve employees.

Fund Group #1:

Fund Group #1 reported that one of its access persons based outside the United States purchased $34,000 of the equity securities of a large foreign company on a foreign stock exchange. The transaction was neither pre-cleared nor reported in a timely manner. The fund group represented that authorization to purchase would not have been granted had pre-clearance been requested. The fund group concluded that the person's failure to pre-clear and report was not intentional and was an isolated incident. The fund group ordered the person to (a) sell all the shares purchased in the unauthorized transaction; (b) disgorge his profits to the funds holding shares of the foreign company; (c) pay a penalty to those funds equal to the amount of the unauthorized purchases, i.e., $34,000, and (d) refrain indefinitely from any personal transactions (other than exempt transactions), subject to reappraisal after one year.

Fund Group #2:

Fund Group #2 reported that it had censured one of its adviser's employees for failing to pre-clear, as required by the adviser's code of ethics, a number of personal transactions over a period of approximately 2 to 3 months. The employee was absent from work during a part of that period and claimed that he had asked one of his subordinates to obtain the necessary pre-clearance. Management concluded that the employee's absence did not excuse his failure to obtain written pre-clearance, and formally censured him by placing a reprimand in his compliance file. Because management determined that, had the requisite pre-clearance procedures been followed, each transaction would have been approved, the employee was not ordered to disgorge profits.

Fund Group #3:

Fund Group #3 reported one violation of the adviser's code and one violation of one of its fund's codes.

One incident involved an officer of the investment adviser and the funds it manages who is not involved in any portfolio management activities. This individual sold securities on the same day that one of the adviser's non-investment company clients sold the same securities. The transaction violated the adviser's policy prohibiting access persons from selling a security within seven days of a client's sale at a price more favorable than that obtained by the client. The individual failed to enter his proposed transaction in the adviser's computer checklist and was thus unaware of the client's contemporaneous

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1/ For purposes of this Exhibit, significant remedial action includes any action that has a pecuniary effect on an individual, such as firing, suspending, or demoting the person, or requiring the reversal of a trade or the disgorgement of profits. Significant remedial action also includes any non-pecuniary action that could affect the person's promotion opportunities, such as reassignment, suspension with pay, or formal censure.

transaction. The adviser's compliance personnel quickly discovered the violation and the individual agreed to disgorge his profit on the transaction (approximately $2,200) to the adviser's client.

The other incident involved a non-interested director who violated the fund's code by purchasing call options on a stock that had been sold by the fund during the previous 15 days. The director was aware of the fund's transactions in the underlying stock, but did not realize that those transactions prohibited him from purchasing options on the stock. The adviser's compliance department discovered the violation on the same day as the director's options transaction and explained to him why the transaction was improper. The director immediately sold all of his call options, sustaining a loss of approximately $1,600.

Fund Group #4:

Fund Group #4 reported violations of the investment adviser's code of ethics by four employees.

In the first incident, a fund manager purchased securities for his personal account and the next day purchased the same securities for two of his funds. The manager was given a written notice and warning and was fined $600.

In the second incident, a fund manager, without obtaining prior approval, sold out of his personal account securities that also were held by the fund he managed. The manager was given a written notice and warning and was required to cancel the transaction at his own expense.

In the third incident, one of the adviser's marketing employees failed to pre-clear a transaction that involved a security on the adviser's restricted list. The employee was given a written notice and warning and was required to disgorge his $100 profit.

In the fourth incident, a senior analyst violated a code provision that allowed employees to buy or sell up to 1,000 shares per day of securities on the restricted list if the securities had a market capitalization of at least $1 billion. The analyst exceeded the 1,000-share limit. He was given a written notice and warning and required to disgorge his $1,000 profit.

Fund Group #5:

Fund Group #5 reported two incidents involving violations of the adviser's code of ethics by four of its employees.

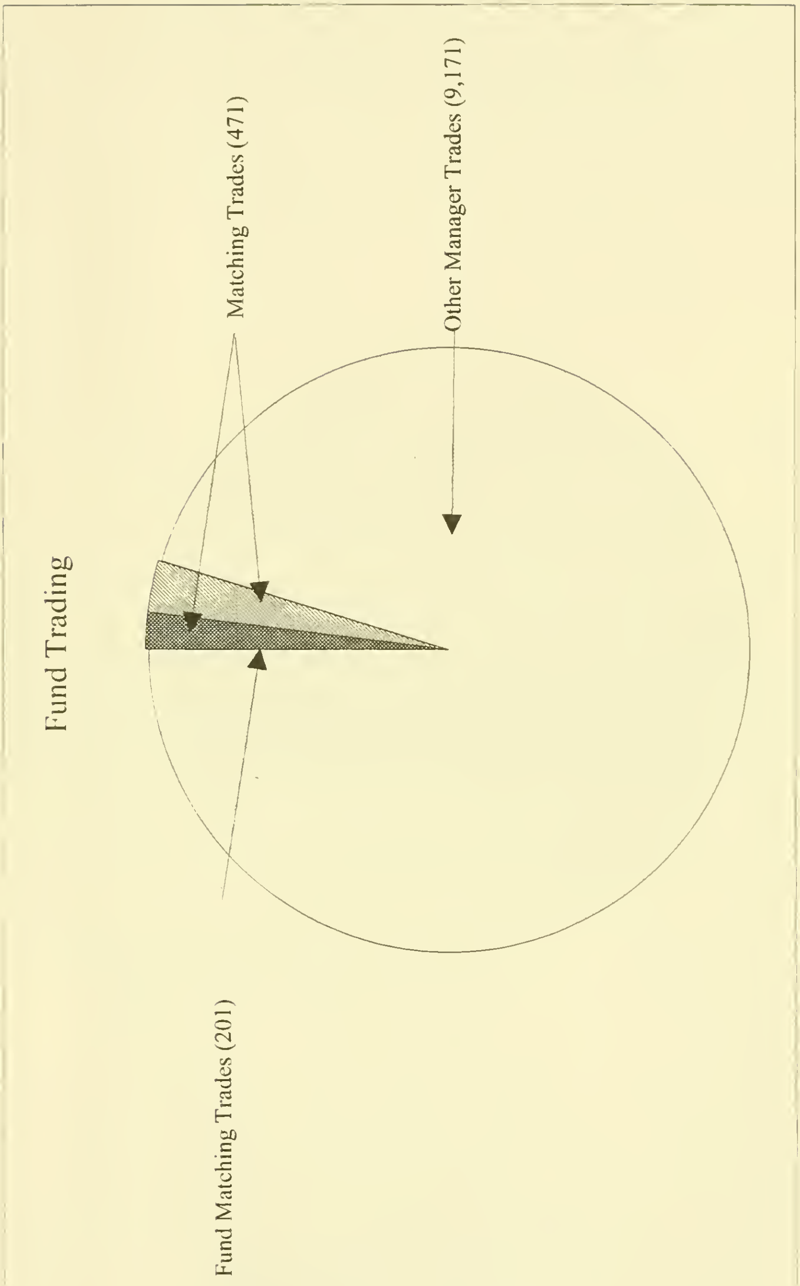
In one incident, a fund manager failed to obtain prior approval of several securities transactions effected by an investment partnership over which he exercised investment discretion. In addition, the manager failed to report these securities transactions within ten days, as required by the adviser's code. The fund manager was given a written reprimand and warned that future violations of the adviser's policies on personal securities transactions could be grounds for immediate termination.

In the other incident, a fund manager, an analyst, and a trader purchased in the aggregate 3,100 shares of a single company, and thereafter sold 1,100 of the shares. The individuals submitted written requests for approval on the same day as the transactions, but not until after the transactions were executed. Because the transactions were not pre-approved, the adviser's general counsel directed that all of the transactions be cancelled.

Exhibit D

	Data Without Fund X (1,052 Funds)	Data With Fund X (1,053 Funds)	Fund X (1 Fund)
Total Number of Fund Managers	618	622	4
Total Number of Fund Managers Who Traded	349	353	4
Total Number of Personal Trades by All Managers	9,843	13,249	3,406
Average Number of Personal Trades Per Manager	15.9	21.3	851.5
Average Number of Personal Trades Per Manager Who Traded	28.2	37.5	851.5
Total Number of Matching Trades	471	1,618	1,147
Average Number of Matching Trades Per Manager	0.8	2.6	286.8
Average Number of Matching Trades Per Manager Who Traded	1.3	4.6	286.8
Total Number of Fund Matching Trades	201	1,348	1,147
Average Number of Fund Matching Trades	0.3	2.2	286.8
Average Number of Fund Matching Trades Per Manager Who Traded	0.6	3.8	286.8

Exhibit E


Fund Trading
Matching Trades (471)
Other Manager Trades (9,171)
Fund Matching Trades (201)

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